

2000

# The Secrecy Interest in Contract Law

Omri Ben-Shahar

*University of Michigan Law School*

Lisa Bernstein

Available at: <https://repository.law.umich.edu/articles/1539>

Follow this and additional works at: <https://repository.law.umich.edu/articles>



Part of the [Contracts Commons](#), [Legal Remedies Commons](#), [Litigation Commons](#), and the [Privacy Law Commons](#)

---

## Recommended Citation

Ben-Shahar, Omri. "The Secrecy Interest in Contract Law." L. Bernstein, co-author. Yale L. J. 109, no. 8 (2000): 1885-925.

This Article is brought to you for free and open access by the Faculty Scholarship at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Articles by an authorized administrator of University of Michigan Law School Scholarship Repository. For more information, please contact [mlaw.repository@umich.edu](mailto:mlaw.repository@umich.edu).

# Essays

## The Secrecy Interest in Contract Law

Omri Ben-Shahar<sup>†</sup> and Lisa Bernstein<sup>††</sup>

A long and distinguished line of law-and-economics articles has established that in many circumstances fully compensatory expectation damages are a desirable remedy for breach of contract because they induce both efficient performance and efficient breach.<sup>1</sup> The expectation measure, which seeks to put the breached-against party in the position she would have been in had the contract been performed, has, therefore, rightly been

---

<sup>†</sup> Assistant Professor of Law and Economics, University of Michigan.

<sup>††</sup> Professor of Law, University of Chicago. We would like to thank Douglas Baird, Edward Bernstein, Brian Bix, Ed Cooper, Jacob Corré, Richard Epstein, Philip Hamburger, Jason Johnston, Avery Katz, Mary La Brec, Bill Landes, Walter Kamiat, Dan Klerman, Eugene Kontorovich, Rick Lempert, Saul Levmore, Ronald Mann, Ed Morrison, Eric Posner, Alan Schwartz, Steven Shavell, Michael Trebilcock, Dina Warner, James J. White, Aviva Zornberg, and participants at the American Law and Economics Association 1999 Panel on Contracts, the Georgetown Law and Economics Workshop, the University of Toronto Law and Economics Workshop, and the Canadian Law and Economics Association 1999 Annual Meeting, the University of Chicago Law and Economics Workshop, and the University of Michigan Law and Economics Workshop, for helpful comments. Professor Bernstein would also like to thank the Lynde and Harry Bradley Foundation Fund at the University of Chicago, the Sarah Scaife Foundation Fund at the University of Chicago, and National Science Foundation Grant, SBR-9422795, for financial support, and she would like to thank the Hebrew University of Jerusalem for logistical support.

1. See, e.g., Steven Shavell, *Contracts*, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 436, 439 (Peter Newman ed., 1998) [hereinafter Shavell, *Contracts*] (“Higher damages than the expectation measure might induce performance when it is inefficient, and lower damages might induce breach when that is inefficient.”). The expectation measure has, however, been shown to provide inefficient reliance incentives. For the seminal article refining the circumstances in which expectation damages are desirable, see Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466 (1980). For a general discussion of and bibliographies on the economic analysis of damages, see Aaron S. Edlin, *Breach Remedies*, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, *supra*, at 174; and Paul Mahoney, *Contract Remedies: General*, in ENCYCLOPEDIA OF LAW AND ECONOMICS (Boudewijn Bouckaert & Gerrit De Geest eds., 2000).

chosen as the dominant contract default rule.<sup>2</sup> It does a far better job of regulating breach-or-perform incentives than its leading competitors—the restitution measure, the reliance measure, and specific performance.

This Essay does not directly take issue with the economic literature demonstrating the general desirability of expectation damages. Rather, it suggests that the literature is implicitly based on the assumption that it is costless for the breached-against party to reveal the information necessary to establish the magnitude of expectation damages. It then argues that in real-world transactional contexts characterized by asymmetric information and the availability of broad pretrial discovery rights, the expectation measure may not be as desirable a remedy as the existing literature suggests.

The core intuition that this Essay develops is simple. When a breach occurs and expectation damages are sought, the expectation measure will often include lost profit. Lost profit is typically calculated on the basis of business information related to the promisee's operations, such as materials and labor costs, inventory size, availability of alternative suppliers, the identity of her downstream contracting partners (customers), and, in the case of newer businesses, her business plan. This and other information revealed during the discovery process may be information that the promisee would prefer to keep private. First, revealing the information might damage her bargaining position in future contract negotiations with this or another transactor and might lead to her having to pay a higher price in future transactions. The promisee's weakened bargaining position arises not only because the promisor will know that, in the event of breach, he will have to pay higher damages, but also, and more importantly, because he will learn the true value of performance to the promisee. Knowing the value of performance to the promisee should enable the promisor to extract a greater share of the bargaining surplus in subsequent transactions. Second, if, at the time a dispute arises, there are other executory contracts between the transactors, the promisor may be able to use the information he obtains during the pretrial discovery process to engage in profitable holdup under these other contracts. Finally, even if the promisee does not intend to transact with the breaching promisor again, the information revealed during the course of the dispute may be used by other transactors with whom the promisee has ongoing relationships, to engage in holdup, to justify demands for adequate assurances of performance, or to extract additional increments

---

2. Scholars who have adopted primarily noneconomic approaches to contract law have also endorsed the expectation measure. For example, Charles Fried argues that

[i]f I make a promise to you, I should do as I promise; and if I fail to keep my promise, it is fair that I should be made to hand over the equivalent of the promised performance.

In contract doctrine this position appears as the expectation measure of damages for breach.

CHARLES FRIED, *CONTRACT AS PROMISE* 17-28 (1981).

of the bargaining surplus in future negotiations.<sup>3</sup> The revelation of the information may also weaken her bargaining position vis-à-vis banks,<sup>4</sup> unions,<sup>5</sup> insurance companies, and secured creditors, as well as damage her competitive position in a market.<sup>6</sup> More generally, to the extent that the

---

3. The intuition developed in the text builds on and extends a literature that has focused on understanding the way in which default rules could be structured to induce transactors to reveal information at the bargaining stage of their relationship, which would, in turn, enable them to obtain the efficiency benefits of contracting on the basis of commonly shared information. See, e.g., Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989) (discussing the idea of information-forcing default rules); Lucian Arye Bebchuk & Steven Shavell, *Information and the Scope of Liability for Breach of Contract: The Rule of Hadley v. Baxendale*, 7 J.L. ECON. & ORG. 284 (1991) (examining how the foreseeability limitation on contract damages affects transactors' incentives to communicate information about the magnitude of their expected harm). For an intuitive overview of the arguments in these papers, see also Ian Ayres, *Default Rules for Incomplete Contracts*, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, *supra* note 1, at 585. In particular, this Essay focuses on a concern that was introduced into this literature by Jason Johnston—namely, the idea that well-informed parties may fail to bargain around even highly undesirable default rules when doing so might force them to reveal information they would prefer to keep private. See Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615 (1990). For articles further modeling and discussing how these types of informational and strategic concerns affect bargaining behavior, see, for example, Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729 (1992), which explores parties' incentives to contract around default rules when doing so is costly and reveals information; and Benjamin E. Hermalin & Michael L. Katz, *Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach*, 9 J.L. ECON. & ORG. 230 (1993), which analyzes the role of default rules when contracts are incomplete due to asymmetric information. For a recent addition to the literature that suggests additional reasons why transactors who expect to have high damages from breach may not want to communicate this information *ex ante*, see Barry E. Adler, *The Questionable Ascent of Hadley v. Baxendale*, 51 STAN. L. REV. 1547 (1999).

4. For example, if a buyer-manufacturer sues the supplier of a component of an important product for breach of the warranty of quality, the information revealed in the suit (such as profit forgone, the availability or nonavailability of alternative suppliers, and the delay in getting the product to market) might lead a bank to restrict its line of credit to the manufacturer.

5. Revealing its profitability and its cost structure may damage a firm's bargaining position vis-à-vis its unions during collective bargaining, causing it to incur an intra-firm secrecy cost. Similarly, revealing some employees' salaries in a nonunion setting might lead to unrest in the workforce or demands for salary parity.

6. This aspect of the secrecy interest is of increasing importance given the recent growth in a type of business arrangement known as "coopetition," in which "firms that are competitors, sometimes even bitter rivals, agree to cooperate in specific market situations." Kenneth James, *Sometimes, It Pays To Sleep with the Enemy*, BUS. TIMES, Mar. 16, 1999, at 14. "A company could find itself serving as competitor, buyer, supplier, and party to another firm on any given day." Harvey Meyer, *My Enemy, My Friend*, J. BUS. STRATEGY, Sept.-Oct. 1998, at 42, 44. When the contracts that govern these agreements are breached, secrecy concerns are likely to be very important. Even in the absence of a dispute, managing the flow of information between parties to coopetition agreements is considered one of the most difficult aspects of implementing them:

An obvious disadvantage of these alliances is that your competitor is learning from your operations, too. . . . [F]or that reason, you might want to assign someone to oversee the alliance [that is, the competition agreement] to, among other things, prevent information from a part of your business that's involved in head-to-head competition with an alliance partner from inadvertently slipping into the competitor's hands. . . . [And it is desirable that] every coopetition have a pre-arranged exit strategy that takes into account each firm's intellectual property and other resources.

*Id.* at 45-46.

value of a firm is based on the value of the private information it possesses—whether this information takes the form of a customer list or any of a variety of forms of intellectual property—legal rules that require the revelation of this information in order to obtain a remedy for breach of contract or to enforce any other substantive legal right, may be undesirable.

Recognizing that an aggrieved party will often prefer to keep the information necessary to establish the magnitude of expectation damages private suggests that while the traditional literature on remedies has focused on the aggrieved party's interest in being made whole (her "compensatory interest"), there is another, potentially conflicting interest that needs to be taken into account, namely her desire to keep information private (her "secrecy interest"). Although the secrecy interest and the compensatory interest are often in direct conflict, they cannot be reconciled simply by elevating one over the other *ex post*. When the secrecy interest is sufficiently strong, the cost of revealing the underlying private information may well exceed the aggrieved party's expected recovery at trial. As a consequence, the aggrieved party may not file suit and may therefore receive no compensation. Because the existence of the promisee's secrecy interest will often be known to a promisor who has either breached or is contemplating breach, the secrecy interest may undermine the credibility of the promisee's threat to sue.<sup>7</sup> This in turn suggests that once the effect of the secrecy interest on the aggrieved party's incentive to sue is taken into account, it may be necessary to rethink the wisdom of fully compensatory expectation damages. In contracting contexts in which the secrecy concern is important,<sup>8</sup> the use of a fully compensatory expectation measure in a

---

A "secrecy interest" vis-à-vis competitors may also exist even in more standard contractual settings. Consider, for example, a manufacturer of a product who has invented a new low-cost production process but who decides not to patent it because of the difficulty of detecting infringers. In such a context, the manufacturer would be reluctant to sue any outside suppliers whose inputs contributed to the product, or any buyers of the product who cancelled orders, since she would have to reveal her unit cost either to recover lost profit as part of the expectation measure or to establish herself as a lost-volume seller. *See infra* note 51. If she did this and her costs were revealed to be far below her competitors' costs, competitors would conclude she had a trade-secret production process and might try to hire away her employees to obtain it.

7. A threat to sue is credible if, in the absence of settlement, the plaintiff would find it in her interest to maintain the suit through trial.

8. It is difficult to construct an accurate empirical measure of the economy-wide importance of the secrecy interest. Most evidence suggesting that secrecy is important might be partly explained by other considerations. Although some examples of plaintiffs' secrecy interests can be found in decided cases such as *Allied Cannery & Packers, Inc. v. Victor Packing Co.*, 209 Cal. Rptr. 60 (Ct. App. 1984), discussed *infra* text accompanying notes 56-58; and *Louis Weinberg Assocs. v. Monte Christi Corp.*, 15 F.R.D. 493 (S.D.N.Y. 1954), discussed *infra* note 98, even if most aggrieved parties had a secrecy interest, the theory discussed in the text suggests that very few of them would sue. As a consequence, decided cases in which a plaintiff's secrecy interest is apparent are likely to be uncommon. Nevertheless, decided cases do provide substantial evidence that the types of secrecy concerns discussed in the text are important. Case reports are replete with references to defendants' attempts to keep private just the type of information that plaintiffs are also likely to prefer to keep secret. *See* cases cited *infra* notes 97-98. This selection effect, which

regime with liberal rules of civil discovery may fail to achieve the widely accepted remedial goal of full ex post compensation. It may also fail to induce efficient breach-or-perform decisions because promisors will realize that promisees with a sufficiently strong secrecy interest may not have a credible threat to sue. In addition, the availability of the expectation measure may, in some contexts, lead a promisor to breach solely in the hope that a promisee will sue and that he will be able to obtain valuable information.

This Essay develops the concept of the secrecy interest in more detail and considers how taking it into account might contribute to the debate over the desirability of several of the Code's remedial provisions, the remedial structure of the new proposed Code,<sup>9</sup> and aspects of existing adjudicative procedures. It argues that given the liberal approach to discovery in effect in American jurisdictions, the Code's remedial provisions are not mere default rules, but rather are quasi-mandatory rules that cannot be fully contracted around. It then suggests that the Code and the rules of civil procedure should be amended in ways that enable contracting parties to opt for damage measures and discovery procedures that do not require them to reveal private, firm-specific information. More broadly, the Essay demonstrates that there is often a hidden, secrecy-related cost to obtaining compensation, and suggests that this cost may account, in part, for businessmen's hostility to the economists' notion of efficient breach.

Part I develops the theoretical claim. It explores the tension between protecting an aggrieved party's secrecy interest and protecting her compensatory interest. After introducing the distinction between subjective damage measures that require the revelation of firm-specific information and objective damages measures that do not, it suggests that in devising optimal remedies it is essential to take into account the type of information that the remedy requires the parties to provide rather than merely the magnitude of the recovery permitted. Part II considers how taking into account the aggrieved party's secrecy interest might change the standard analysis of various Code provisions and proposed Code provisions as well as their associated Official Comments and common-law doctrines. It also considers ways in which remedial rules as well as the rules and doctrines relating to cover, mitigation, performance, and adequate assurances of performance might be restructured to strike a more desirable balance between the secrecy interest and the compensatory interest. Part III explores the implications of identifying the secrecy interest for the design of adjudicative procedures. Finally, Part IV concludes by suggesting that the

---

leads to relatively few cases being brought in which plaintiffs have substantial secrecy interests, may account, in part, for the failure of courts to develop common-law doctrines that take the secrecy interest into account.

9. References to the "proposed Code" are to the U.C.C. art. 2 (Proposed Revisions 1999).

Code's own stated goal of protecting the compensatory interest might be better served if the law were structured to take the secrecy interest into account.

## I. THE COMPENSATORY INTEREST AND THE SECRECY INTEREST IN CONTRACT DAMAGES

### A. *Introducing the Secrecy Interest*

The economic literature on damage remedies has focused primarily on two polar cases—discrete exchange between strangers where expectation damages are superior (traditional law and economics),<sup>10</sup> and long-term, repeat-play transactions among transactors who are perfectly constrained by reputation bonds and therefore find recourse to damages unnecessary (game theory).<sup>11</sup> The literature has, however, ignored an important class of transactions, exemplified by buyer-supplier relationships in nonperfectly competitive markets, where reputation is a significant, yet imperfect, constraint on transactors' behavior. In these relationships transactors either deal with one another on a repeat basis or with others in the market over an extended period of time, under numerous short-term contracts whose price and other terms are negotiated anew with some regularity.<sup>12</sup> Because buyers and suppliers in relationships of this sort are constantly negotiating and renegotiating their agreements, each desires to keep private the information that would reveal its reservation price—that is, the price at which each would find it desirable to walk away from the proposed transaction.<sup>13</sup> As a

---

10. For an overview of this literature, see the sources cited *supra* note 1.

11. For an overview of this literature, see DOUGLAS G. BAIRD ET AL., *GAME THEORY AND THE LAW* 165-78 (1994), and the sources referenced therein.

12. The literature has also ignored a class of long-term contracts, under which if a dispute arises and the contract is not terminated, the breaching party may be able to acquire information during the course of the dispute that will enable him to engage in holdup during the life of the contract.

13. To illustrate the advantage of keeping information private, consider the following example. Suppose a buyer and a seller are bargaining over the price of one unit of a good and that there are no third parties bidding on or offering to sell this good. Assume that the buyer's valuation of the unit is distributed uniformly between \$100 and \$200, that the buyer knows her actual valuation, that the seller only knows the distribution of valuations among buyers as a group, and that the seller's cost of producing the good is zero, so he would be willing to sell it for any price. Further assume that there is only one round of bargaining in which the seller makes one take-it-or-leave-it offer and that the buyer would accept any offer that would give her a nonnegative payoff, and would reject any offer that would leave her with a negative payoff.

Consider the thought process of a buyer who is trying to decide whether she is better off concealing or revealing her private information. Such a buyer will reason that if she conceals the information, the seller will bargain with her as if she is a random draw from the distribution of buyer valuations and will demand the price that maximizes his expected return. In such a situation, the seller will demand a price of \$100. At this price, the probability that the offer will be accepted is 1 (which corresponds to the likelihood, from the seller's point of view, that the buyer's valuation exceeds \$100), so the seller's payoff would be a sure \$100. If, however, the seller asked

consequence, when a dispute arises, an aggrieved party may often find it desirable to seek or settle for significantly less than full compensation if doing so enables her to keep valuable information secret. The expected gain from having a stronger bargaining position in future transactions and not weakening her bargaining position vis-à-vis other executory contracts with this or other transactors often outweighs the benefits of a higher immediate monetary recovery. In some contracting contexts, the long-term monetary and strategic value of an aggrieved party's secrecy interest outweighs the monetary value of her short-term compensatory interest.

The tension between satisfying the secrecy interest and satisfying the compensatory interest is greater the less competitive the market and the longer the information in question retains its secrecy value.<sup>14</sup> The tension is also more pronounced the longer the breached-against party thinks she will want to deal with this transactor or, in the case of information with a market-wide value, transactors in this particular market.<sup>15</sup>

---

for a higher price, his expected payoff from the transaction would be lower because the higher price he might obtain would be more than offset by the reduced likelihood that the offer would be accepted. For example, a price of \$120 will be accepted with probability 0.8, giving the seller an expected payoff of  $0.8 \times \$120 = \$96$ . Similarly, a lower price would not affect the likelihood that the offer will be accepted (which is already 1), but given the reduction in price would reduce the seller's expected revenue from the transaction. In such a situation, given that the seller would demand \$100, the buyer would accept the offer, and her benefit from the transaction would be her true valuation less \$100. Thus, unless her true valuation is the lowest possible one (\$100), the buyer will enjoy a positive surplus from the transaction. (For example, if the buyer's actual valuation turns out to be \$120, she will obtain a net benefit of \$20.) If, instead, the buyer were to reveal her true valuation to the seller, she would be *worse off*. The seller would then demand a price equal to (or slightly under) the buyer's known valuation, thereby fully exploiting his bargaining power. In such a situation, the buyer's share in the surplus will be reduced to nearly zero. Qualitatively similar results follow regardless of the distribution of bargaining power between the buyer and the seller.

14. In general, markets are less competitive the fewer alternative trading partners each transactor has and the larger the switching or search costs that are involved in terminating one contracting relationship and entering into a new one. Unlike in perfectly competitive markets, where prices are competed down to the point at which transactors do not make more than normal (standard) profits, in less competitive markets transactors negotiating a contract price are also bargaining over the division of the surplus created by the greater-than-normal profits arising from the transaction. The less competitive the market, the greater the potential surplus to be divided. Because transactors may be able to secure a greater fraction of the bargaining surplus by keeping their information private, their secrecy interests become stronger the larger the surplus, that is, the less competitive the market.

15. Returning to the example discussed *supra* note 13, suppose that the buyer's actual valuation of the unit is \$120. If this information remains private, she would expect to obtain a net gain of \$20 in each subsequent transaction (recall from above that an uninformed seller will demand a price of \$100). In such a situation, if a breach occurred and the buyer thought that her relationship with the seller was likely to continue for a long time (and no similarly advantageous alternative contracting partners were available), she might prefer to give up the right to recover full expectation damages, here a one-time payment of \$120, in order to secure a future stream of transactions each producing a net benefit of \$20 each. Even if the buyer significantly discounts future gains, the longer the buyer thinks the contracting relationship will last, the greater the bargaining advantage the buyer enjoys from keeping information private.



Before attempting to structure remedies in a way that will be sensitive to both interests, it is important to consider why it might be desirable to take the secrecy interest into account in designing remedies. From a social point of view, private information is a barrier to mutually beneficial exchange;<sup>16</sup> it is a type of transaction cost that may prevent transactors from capturing a potential surplus<sup>17</sup> or may lead them to enter into inefficient transactions.<sup>18</sup> In an ideal world, more efficient bargaining outcomes are reached when information is commonly shared.<sup>19</sup> In such a world, it would be desirable to structure the legal rules to give transactors incentives to reveal, rather than obscure, their private information, thereby inducing them to enter into exchanges whose terms are "First-Best" from a social perspective.<sup>20</sup> In the real world, however, transactors' private interest in keeping information secret makes the goal of full information revelation within a particular market unattainable. Rather than reveal such information, transactors will often prefer to forgo suit in the event of breach, change their patterns of contracting, change important aspects of the terms on which they deal, or forgo the transaction entirely. A manufacturer might, for example, choose to produce a key component of a product in-house even if she could purchase it more cheaply, if, in the event of a

---

16. For a general discussion of contracting under asymmetric information and a bibliography of technical papers on the subject, see BAIRD ET AL., *supra* note 11, at 79-158.

17. For transactors to maximize the potential surplus, it is also necessary to induce efficient reliance expenditures. When the level of reliance expenditures cannot be directly stipulated in the contract, perhaps because there are ex post verification problems, it is nevertheless possible to induce efficient reliance investments if the ex post value obtained by each party is observable. See, e.g., Shavell, *Contracts*, *supra* note 1, at 442 (surveying the economic literature on structuring contracts to induce efficient reliance investments). However, when one or both transactors' ex post valuations are unobservable, their ability to write a contract that will induce efficient reliance is severely limited.

18. See generally ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 84-86 (2d ed. 1995) (suggesting that asymmetric information about reservation values is one reason transactors may fail to reach an agreement); David de Meza, *Coase Theorem*, in 1 *THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW*, *supra* note 1, at 275-78 and sources referenced therein (providing a summary of the economic literature on bargaining in the presence of asymmetric information).

19. In the example *supra* note 13, suppose that the seller's cost of producing the good is \$100 (instead of zero). In this case, the uninformed seller's optimal strategy is to offer a price of \$150. Under this strategy, there is a 0.5 probability that the buyer will reject the offer (the likelihood that the buyer's valuation is less than \$150), and that no transaction will take place. More generally, if the buyer's valuation is greater than \$100 but less than \$150, there will be no transaction even though the transaction is efficient, and a social surplus equal to the difference between the buyer's valuation and the seller's cost will be forgone.

20. A First-Best (or a Pareto-efficient complete-contingent) contract is a contract that cannot be modified in a way that will raise the expected utility of both transactors. Fully informed rational transactors would enter into a First-Best contract if there were no transaction costs and no verification or enforcement problems ex post. See, e.g., Louis Kaplow & Steven Shavell, *Law and Economics*, in *HANDBOOK OF PUBLIC ECONOMICS* § 4.1.1 (Alan J. Auerbach & Martin Feldstein eds., 2000). A Second-Best (or economically incomplete) contract is the best set of contractual terms that the parties can enter into given the existence of transaction costs, asymmetric information, or ex post verifiability and enforceability problems. See *id.* § 4.1.4. This Essay focuses on Second-Best problems arising from asymmetric information.

dispute with an outside supplier, she would have to reveal costly private information. From a policy perspective, the challenge therefore becomes to structure legal rules in general, and damage remedies in particular, to achieve “Second-Best” outcomes in transactional contexts that to a greater or lesser degree will always be characterized by asymmetric information.<sup>21</sup> In particular, damage measures like fully compensatory expectation damages that give efficient breach-or-perform incentives in an ideal world should be replaced or supplemented by measures that take into account the secrecy interest of the aggrieved party and the type of discovery that will be available.

### B. *Objective Versus Subjective Measures of Damages*

In order to discuss how the law ought to reconcile the secrecy interest and the compensatory interest, it is useful to classify potential damage measures into two broad categories. The first category consists of measures that neither require the aggrieved party to reveal nor permit the breaching party to discover firm-specific information (“objective damages”). An example of an objective damage measure is the contract-market differential, which can be established by reference to the contract price and a market price based on either publicly available price quotes or the rates charged by other firms. The second category of damage measures consists of measures that either require the revelation or permit the discovery of firm-specific information (“subjective damages”). An example of a subjective damage measure is the expectation remedy, which seeks to put the aggrieved party in the same position she would have been in had the contract been performed. The expectation measure is calculated on the basis of such measures as the profit lost by *this* promisee, the incidental damage incurred by *this* promisee and, as in *Hadley v. Baxendale*,<sup>22</sup> the type of information about special circumstances or potential losses that was communicated by *this* promisee to the breaching party.

---

21. The ex post revelation of information that is required by subjective damage measures and the rules of discovery may also reduce transactors' incentives either to deliberately acquire certain types of information or to invest in the types of innovations and activities whose profitability is dependent on keeping information private. Consider again the manufacturer discussed *supra* note 6, who invents a low-cost production process for a product. If she brings a suit for damages against a supplier of a component, she will have to reveal her cost of production, which may induce her competitors to try to obtain information about her production process. Protecting this type of information from revelation in such a suit would have the beneficial effect of preserving or enhancing transactors' incentives to devise such innovations in the first place. More generally, there are many contracting contexts in which protecting private information ex post is likely to create more efficient ex ante incentives to gather and use information. As a greater proportion of many firms' valuations come to turn on the value of their intellectual property, this consideration is likely to become more important.

22. 156 Eng. Rep. 145 (Ex. 1854).

Generally speaking, objective remedies tend to do a relatively good job of protecting the aggrieved party's secrecy interest, but will often fail to protect her compensatory interest<sup>23</sup> because they do not take transaction-specific elements of value into account. In contrast, subjective remedies seriously jeopardize the aggrieved party's secrecy interest, and while they may appear to be well-suited to the goal of full compensation since they are closely tailored to the actual losses of a particular aggrieved party, they may also jeopardize her compensatory interest, once the interplay between the secrecy interest and the compensatory interest is taken into account. When only subjective remedies like the expectation measure are available, an aggrieved party who is concerned with keeping information private may be reluctant to file a suit. Such a party may rationally prefer to forgo her compensatory interest because pursuing a subjective remedy would give the defendant the right to obtain her valuable private information through discovery. Moreover, in situations in which the existence of the potential aggrieved party's secrecy interest is known to a promisor contemplating breach, the would-be aggrieved party's threat to sue in the event of breach may lose its credibility, thereby increasing the likelihood of breach and further jeopardizing her compensatory interest. This analysis suggests that while contract theorists have focused on figuring out the optimal magnitude of contract damages, it is also crucial to take into account the types of information a particular damage measure will force the aggrieved party to reveal, and permit the breaching party to discover, if a dispute arises.

It is therefore necessary to consider whether it is possible to find an alternative to the subjective, perfectly compensatory expectation measure that creates more efficient breach-or-perform incentives and better protects the aggrieved party's compensatory interest once the effect of the remedy on the aggrieved party's incentive to file suit is taken into account.

### C. *Average Expectation Damages*

In attempting to structure such a remedy, it is useful to consider a situation in which a promisor contemplating breach does not know the actual loss that the breach will cause the promisee—a paradigmatic case of asymmetric information. In deciding whether or not to breach, the promisor will attempt to estimate the expected value of the damages he will be ordered to pay if suit is brought and will make his decision accordingly. In such a situation, if the law imposed a measure of damages that did not condition on the aggrieved party's subjective loss but was equal to the promisor's estimate of the aggrieved party's loss—for analytic convenience

---

23. See sources cited *infra* notes 49, 93 (suggesting that contract-market damages rarely correspond to the aggrieved party's actual loss).

think of this as “average expectation” damages across the market—the promisor’s breach-or-perform decisions under this “flat” measure of damages would be the same as they would be if the law provided for the recovery of fully compensatory expectation damages. As has been recognized in the tort literature, accuracy in the assessment of damages is socially beneficial only if it can improve incentives *ex ante*—that is, only if the person contemplating an action has access to the more accurate information at a reasonable cost at the time he is deciding how to act.<sup>24</sup> In contracting contexts where the promisee’s value of performance is private information, imposing a subjectively tailored damage measure *ex post* would not give the promisor the optimal incentive to perform or breach that it would in a world of full information. In fact, as compared to an “average expectation” measure, the imposition of subjectively measured expectation damages would compromise the aggrieved party’s secrecy interest without creating any improvement in the promisor’s breach-or-perform incentives.

Moreover, the use of subjectively tailored expectation damages designed to fully compensate the aggrieved party may actually result in her receiving *less* compensation than she would under an undercompensatory objective measure, once the effect of her secrecy interest on her incentive to sue is taken into account.<sup>25</sup> If, however, a court were to apply some flat measure of damages that did not require the revelation of firm-specific

---

24. See Louis Kaplow, *The Value of Accuracy in Adjudication: An Economic Analysis*, 23 J. LEGAL STUD. 307 (1994); Louis Kaplow & Steven Shavell, *Accuracy in the Assessment of Damages*, 39 J.L. & ECON. 191 (1996); see also Lucian Arye Bebchuk & Steven Shavell, *Reconsidering Contractual Liability and the Incentive To Reveal Information*, 51 STAN. L. REV. 1615 (1999) (pointing out that a promisor who is uninformed about a promisee’s actual loss cannot take accurately tailored precautions against breach).

25. In many litigation contexts, a plaintiff who does not have a credible threat to take a case to trial—perhaps because litigation costs are larger than her expected recovery, giving her claim a negative expected value—may nevertheless be able to extract a settlement. For an overview of the wide variety of models and intuitions that have been developed to explain such settlements, see generally Lucian A. Bebchuk, *Suits with Negative Expected Value*, in 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, *supra* note 1, at 551. However, a plaintiff whose claim has a negative expected value because her secrecy interest outweighs her expected recovery is less likely to obtain a settlement, because there is an important difference between the effects of traditional litigation costs and secrecy costs on the credibility of a plaintiff’s threat to sue. Ordinary litigation costs are generally assumed to be accrued in relatively continuous and fairly uniform fashion throughout the litigation process. At each stage of discovery, the cost of moving to the next stage is relatively small, so a plaintiff’s threat to go forward is likely to be credible. In contrast, a large portion of a plaintiff’s secrecy costs are incurred in a lump sum early on in the discovery process, particularly since the passage of FED. R. CIV. P. 26(a)(1)(C), which imposes a duty on the plaintiff immediately to disclose “a computation of any category of damages claimed by the disclosing party, making available for inspection and copying . . . the documents or other evidentiary material, not privileged or protected from disclosure, on which such computation is based.” As a consequence, a plaintiff’s threat to proceed through the early stages of discovery is not likely to be credible if she has a substantial secrecy interest. See generally LUCIAN ARYE BEBCHUK, ON DIVISIBILITY AND CREDIBILITY: THE EFFECTS OF THE DISTRIBUTION OF LITIGATION COSTS OVER TIME ON THE CREDIBILITY OF THREATS TO SUE (Harvard Program in Law & Econ. Discussion Paper No. 190, 1996) (demonstrating that the credibility of a plaintiff’s threat to sue is affected by the sequence, magnitude, and timing of the plaintiff’s litigation costs).

information, the aggrieved party might well file suit and recover the “flat” measure of damages, thereby receiving at least some compensation.<sup>26</sup>

In theory, then, in some transactional contexts characterized by asymmetric information, the award of a flat damages measure set at an amount approximating “average expectation” damages would be superior to the award of subjectively tailored expectation damages. Unlike in the tort context, however, where actuarial tables make the award of a meaningful average measure of damages feasible, using an “average expectation” measure in the contracts context would require courts to make factual determinations—such as the underlying statistical distribution of the profit parameter—that in most cases they are ill-equipped to make.<sup>27</sup>

The challenge, then, is to think about feasible alternatives to the analytically attractive “average expectation” measure. However, before doing so, it is useful to explore in more detail how transactors with secrecy interests might bargain in the shadow of different types of default rules and to consider the ways that they might attempt to hide, signal, or communicate information.

26. Even if the flat measure was somewhat overcompensatory, the deadweight loss created by the efficient breaches that it prevented might be more than offset by the deadweight cost of the inefficient breaches it prevented.

27. It is far more difficult to figure out the distribution of profit and mean profit across a broader population than it is to measure actual damages, even when such damages include highly idiosyncratic components. Moreover, evidence regarding average lost profit may not be accessible to the parties. The secrecy concerns of third-party market participants as well as antitrust limitations on gathering information on competitors' prices and costs would limit parties' access to this type of information.

However, damage measures that are conceptually similar to average expectation damages are sometimes used to establish the expected lost profit of a new business. In *Chung v. Kaonohi Center Co.*, 618 P.2d 283, 291-92 & nn.7-9 (Haw. 1980), for example, the court admitted expert testimony on the anticipated lost profit of a new business that was based on “three different valuation approaches—a reproduction cost analysis[, which is “[t]he cost, based on current prices, of reproducing the assets of the business”], a comparative market analysis [in which “[r]ecently sold businesses of a similar nature are compared by both gross and net income to the subject business to indicate a fair market value”], and an income stream analysis.” For additional permissible techniques, see 2 ROY RYDEN ANDERSON, DAMAGES UNDER THE UNIFORM COMMERCIAL CODE § 11:27 (1991). Given that these techniques are currently used in new business cases, it might be desirable to permit a plaintiff to use them in the established business context as well, even though they are likely to be systematically biased downward relative to the true harm suffered since the burden of proof placed on those who seek to establish lost profit using these measures is extraordinarily high and some elements of this type of harm are still often excluded by courts on the grounds that they have not been established with sufficient certainty. See *id.* §§ 11:22, 11:26. Some commentators have suggested that courts should permit the use of industry averages to establish aggregate lost profit when the dispersal across the relevant set of firms is small, a rule that makes good sense as a way of meeting the doctrinal requirement of certainty in the new business context. See *Fera v. Village Plaza, Inc.*, 242 N.W.2d 372 (Mich. 1976). This approach, however, would undermine the usefulness of these techniques as a practical solution to problems created by the secrecy interest, because it is precisely when a profit varies across firms that a secrecy interest is most likely to be present. In addition, while using industry averages in this way may open the door to overcompensatory recoveries when the plaintiff has a particularly low cost of production, this is precisely the situation where her secrecy interest is likely to be the greatest. See *supra* note 6.

#### D. *The (Potential) Unraveling of Private Information*

In thinking about how transactors' secrecy interests would affect the ways they bargain in the shadow of different remedy-related default rules, it is important to take into account that while some transactors prefer to keep certain types of information private, others have an incentive to reveal precisely the same types of information in an effort to obtain more favorable terms. Consider, for example, a seller who is negotiating with a buyer who attaches a higher-than-average value to a good. In bargaining with such a buyer, an uninformed seller will behave as if he is bargaining with an average-value buyer. The buyer should therefore be able to retain a greater portion of the consumer surplus than she would if the informational asymmetry were eliminated. Now consider a seller who is negotiating with a buyer who attaches a lower-than-average value to the good. Such a seller will also behave as if he is bargaining with an average-value buyer. As a consequence, a low-value buyer would be hurt by the existence of this asymmetry of information and might do much better if the seller knew her true valuation. Buyers with below-average valuations therefore have a strong incentive to reveal their "type" to sellers in an effort to obtain a lower price. This, in turn, suggests that low-value buyers might trigger an information-unraveling process that would result in a separating equilibrium in which each type of buyer agreed to a liquidated-damages provision reflecting her type.<sup>28</sup>

Although plausible in theory, the unraveling of information is unlikely to occur in practice. First, in order for unraveling to take place, a low-value buyer will have to be able to credibly communicate her type to the seller. The seller will not simply accept the buyer's assertion that she is a low-value type. High-value buyers also have an incentive to pose as low-value buyers, since this may help them capture a larger share of the consumer surplus.<sup>29</sup> As a consequence, a low-value buyer will have to *prove* to the

---

28. For a rigorous discussion of the conditions under which such unraveling might occur, see Robert H. Gertner, *Disclosure and Unraveling*, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, *supra* note 1, at 605. For another mechanism of information-unraveling, whereby buyers with different valuations accept different liquidated-damages provisions, see Alan Schwartz, *The Myth That Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 YALE L.J. 369 (1990) (examining the ability of sellers to "screen" buyers' types through a "menu" of price and liquidated-damages terms).

29. Although a high-value buyer who masquerades as a low-value buyer sacrifices a significant portion of the expectation remedy she could potentially enjoy in the event of breach, and reduces the seller's incentives to take extra precautions to avoid breach, she might nevertheless benefit from misleading the seller. In a market in which the seller has bargaining power, pooling with low-value buyers may enable her to obtain a better price. More generally, the likelihood that high-value types can masquerade as low-value types depends strongly on the relevant market structure. Under the assumption in the text that the relevant markets are far from

seller that she is a low-value buyer in order to induce the seller to deal with her on more favorable terms. Since a buyer's type depends, in part, on her expected profits, she will have to be able to credibly communicate the magnitude of her expected profit to the seller. Profit, however, is not a measure that is observable to the seller. Because profit is calculated on the basis of revenues less costs, in the absence of a way for the seller to be sure that the buyer has completely revealed all relevant information—such as the discovery process—the buyer has a strong incentive to understate her revenues and overstate her costs in order to appear to be a low-value type.<sup>30</sup> As a consequence, credible revelation of information about transactors' true valuations cannot readily occur.

Although a low-value buyer might attempt to communicate information about her true valuation by offering to include a low liquidated-damages provision in the contract, the mere fact of the offer will not credibly reveal information. Because high-value buyers who are vulnerable to extraction of their consumer surplus might also offer to include low liquidated-damages provisions in an effort to convince sellers that their reservation price is low, the fact that a particular buyer offers to include such a provision is a noisy signal that gives the seller little reliable information.<sup>31</sup>

One might also be concerned about the unraveling of information ex post, as low-value buyers unconcerned with secrecy brought suit, leading sellers to conclude that those who did not sue in the event of breach were high-value types. If buyers' decisions about whether or not to sue were based on nothing other than their secrecy interests and their expected recoveries, and if the scope and magnitude of sellers' discovery efforts were determined solely by their desire to obtain as much information as possible about a buyer's type, such unraveling might well occur. In practice, however, this type of unraveling is also unlikely. To see why, consider a low-value buyer who is deciding whether to sue. Even if she gets some next-round price advantage from firmly establishing the upper bound of her price range, she might not sue. First, if her loss is truly small and litigation costs are high, it might not be worthwhile for her to sue. Second, any

---

perfectly competitive, such masquerading is possible, but in a perfectly competitive market it is unlikely. *See* Bebchuk & Shavell, *supra* note 24, at 1620-21.

30. This may be much more difficult to do in a public company given the extensive regime of legally required disclosures. However, since the relevant information in this context may be far more detailed than the legally required disclosures, public companies may also have substantial secrecy interests.

31. A seller who recognizes the high-value buyer's incentive to masquerade as a low-value buyer is likely to ignore or highly discount the informational content of a liquidated-damages provision. Such a seller will respond with a lower price only to the extent that the lower damages reduce the liability (and precaution) costs he will find it desirable to bear. He will not, however, view a low damages clause as a credible signal of the buyer's valuation and will not offer the same price that he would have offered had he thought that he was negotiating with a true low-value buyer.

benefit she might get from revealing this information will only be obtained if she deals with this seller again, or if it helps her in negotiating with other sellers. However, as between these two parties, filing suit is likely to damage their contracting relationship, thereby reducing the likelihood that they will do business together in the future. And, as between the aggrieved party and other transactors, the information-revelation effect may be weak because other transactors may be reluctant to rely on the thoroughness of the breaching party's discovery efforts in a suit in which the amount in controversy is relatively small. Third, it is not always advantageous for a firm to appear to its contracting partners as a very low-profit firm, since this might result in its being offered less advantageous credit terms. Now consider a high-value buyer who is contemplating suit. One possibility is that she will ask for only a low measure of damages. If she does so, a seller might engage in discovery to obtain full information, but he may also forgo all or part of this costly process and accept the buyer's valuation. Although the seller will know his level of discovery effort and will be able to use information about the buyer's true valuation if he obtains it, other transactors will not know how thoroughly he searched the buyer's records. Other transactors may therefore be unable to assess the likelihood that there are other hidden costs or revenues. This, in turn, makes it difficult, if not impossible, for them to determine the buyer's type with much accuracy (although they may still learn many things the buyer prefers to keep private), thus reducing the likelihood that unraveling will occur.

E. *(Potentially) Secrecy-Preserving Subjective Damages*

Recognizing the secrecy interest also has implications for understanding the ways that the two other main measures of contract damages—restitution and reliance—might affect transactors' behavior. Most importantly, it provides a reason that an aggrieved party might prefer to seek restitution or reliance damages rather than expectation damages, even in contexts in which restitution or reliance damages result in a lower recovery and expectation damages are relatively inexpensive to prove.

In theory, restitution damages are measured by reference to the value conferred by the aggrieved party on the breaching party. When strictly applied, they therefore protect the aggrieved party's secrecy interest because they do not require her to reveal private information about her operations. Although restitution damages are generally lower than expectation damages, recognizing the effect of the secrecy interest on the aggrieved party's incentive to sue suggests that the lower restitution remedy may result in more compensation than the expectation measure. Moreover, because restitution damages may, in some contexts, jeopardize the breaching party's secrecy interest, they may in fact provide a greater



deterrent to breach than previously recognized.<sup>32</sup> In fact, recognizing the secrecy interest suggests that it might be desirable to give the aggrieved party the right to freely elect to seek restitution damages regardless of the magnitude of expectation damages because doing so will enhance the credibility of her threat to sue.<sup>33</sup> It also suggests that it might be desirable to develop a more far-reaching restitution measure that could better protect the interests of aggrieved parties with substantial secrecy concerns.<sup>34</sup>

Reliance damages, in contrast, require the aggrieved party to reveal firm-specific information and under current doctrine will often jeopardize her secrecy interest. In general, an aggrieved party may seek reliance damages if expectation damages are either difficult to prove or inadequate.<sup>35</sup> However, a breaching party is entitled to deduct from the reliance measure "whatever he can prove the promisee would have lost if the contract had been fully performed,"<sup>36</sup> and the need to establish the magnitude of this offset gives him access to the discovery needed to establish what expectation damages would have been. This suggests that the availability of reliance damages does not provide much protection to an aggrieved party's secrecy interest.<sup>37</sup> However, if an aggrieved party were permitted to seek

32. Where a bilateral secrecy interest exists, giving either party the right to seek restitution damages in the event of breach may prevent various types of opportunism.

33. In other doctrinal contexts, courts have recognized that the use of damage measures that jeopardize a party's secrecy interest may also compromise her substantive rights. *See, e.g., Snapp v. United States*, 444 U.S. 507, 514-15 (1980) (rejecting the use of a compensation-based remedy for breach of an employee's fiduciary duty—a duty that was defined in part by an employment contract—in favor of a disgorgement measure of damages on the grounds that requiring the employer to demonstrate its actual loss would require it to reveal the very information the employee was supposed to keep secret).

34. However, because restitution for breach of contract is only awarded when a breach is material, and demonstrating the materiality of a breach may also reveal information, this requirement would have to be eliminated to turn restitution into a fully objective remedy.

35. *See* RESTATEMENT (SECOND) OF CONTRACTS § 349 & cmt. a; *see also* *Security Stove & Mfg. Co. v. American Ry. Express Co.*, 51 S.W.2d 572, 575 (Mo. Ct. App. 1932) (permitting the plaintiff to recover reliance damages in a context in which expectation damages would have been nominal).

36. *L. Albert & Son v. Armstrong Rubber*, 178 F.2d 182 (2d Cir. 1949); *see also* E. ALLAN FARNSWORTH, *CONTRACTS* 837 (3d ed. 1999) ("[T]o the extent that the party in breach can prove with reasonable certainty that the injured party's expectation interest was less than its reliance interest, so that performance of the contract would have resulted in a net loss to that party rather than a net profit, the amount of that loss would be subtracted from the cost of reliance.").

37. The difficulty of limiting the scope of discovery when the reliance measure is sought may account, in part, for the fact that in certain types of contracting relationships, settlement norms have arisen that dictate what components of reliance damages should be recompensed in the settlement of particular types of disputes. For example, in his seminal study of the contracting practices of Wisconsin manufacturing concerns, Stewart Macaulay found that even in buyer-supplier contracting relationships in which the aggrieved party would be entitled to recover expectation damages, when breach occurred suits were rarely filed and expectation damages were rarely sought in settlement. Rather, "all ten of the purchasing agents asked about cancellation of orders once placed indicated that they expected to be able to cancel orders freely subject to only an obligation to pay for the sellers' major expenses," that is, some of his reliance expenditures. Similarly, "[a]ll 17 sales personnel asked reported that they often had to accept cancellation." Stewart Macaulay, *Noncontractual Relations in Business: A Preliminary Study*, 25 AM. SOC.

reliance damages regardless of the profitability of the contract, the size of expectation damages, or the ease or difficulty of proving expectation damages, the reliance measure would be transformed into a desirable secrecy-preserving damage measure. If there were an element of reliance expense that was compensable but had a relatively high associated "secrecy cost," the aggrieved party could opt not to request compensation for it, while not forfeiting her right to recover other reliance expenditures.

## F. Conclusion

In sum, recognizing the existence of an aggrieved party's secrecy interest suggests that perfectly tailored, fully compensatory expectation damages may not always be the most desirable remedy for breach of contract. The critique of the expectation measure that emerges from taking the secrecy interest into account differs from most critiques of the expectation measure, which have focused largely on courts' limited ability to verify the magnitude of important components of the expectation measure, such as lost profit.<sup>38</sup> In fact, it is precisely when ex post verification of the aggrieved party's actual loss is cheapest and most accurate that her secrecy interest is most likely to be jeopardized if expectation damages are the sole remedy available in the event of breach.

In thinking about how to restructure remedies to take the secrecy interest into account, it is important to note that even if a significant percentage of litigated disputes are absolute end-game disputes among transactors who will never deal with one another again, the secrecy interest remains important. First, as discussed earlier, an aggrieved party's secrecy interest often extends to keeping information from third parties or intra-firm constituencies such as labor unions. Second, in situations in which a party contemplating breach knows that a potentially aggrieved party has a strong

---

REV. 55, 60-62 (1963). Similarly, another study of contractual relationships between manufacturers and those with whom they deal found that "[o]nly 10% of the manufacturers responding to the *Questionnaire* ever make it their practice to sue upon cancellation of an order," and that "[o]f the total number of manufacturers, 69, who indicated that they are most likely to pursue a particular course of action against a defaulting customer, 30% always or usually take no action at all, 61% settle for expenses incurred, and 9% insist upon a settlement of expenses plus lost profits." Comment, *The Statute of Frauds and the Business Community: A Re-Appraisal in Light of Prevailing Practices*, 66 YALE L.J. 1038, 1061 (1957) (footnotes omitted).

38. See, e.g., Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271, 277 (1979) ("[P]romisees possess better information than courts as to . . . the adequacy of damages . . . because promisees are more familiar with the costs that breach imposes on them."); Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341 (1984) (arguing that courts face severe evidentiary problems in accurately calculating the magnitude of expectation damages); cf. Richard A. Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, 18 J. LEGAL STUD. 105 (1989) (exploring a variety of reasons apart from the difficulty of assessing their magnitude that expectation damages might not be the most desirable remedy).

secrecy interest, he may be more likely to breach and trigger an end-game dispute than he would be if the aggrieved party could opt for some objective measure of damages. Third, recognition of the secrecy interest suggests that making an objective remedy available would prevent some inefficient breaches, thereby reducing the number of end-game disputes that arise. Finally, the use of an objective measure might increase the likelihood that a transactional relationship will be resumed after a breach because it would simplify the issues in dispute, reduce the amount of discovery, and increase the likelihood that a settlement would be reached in cases where liability was clear.

## II. DOCTRINAL APPLICATIONS

Recognizing the “secrecy interest” suggests a number of considerations that need to be taken into account in assessing the desirability of various of the Code’s and proposed Code’s remedy-related provisions—such as liquidated damages, specific performance, capping damages at the aggrieved party’s actual loss, cover, and mitigation. It also suggests that the radical change in remedial hierarchy introduced in the proposed Code—a change that imposes an actual-damages cap on virtually all monetary recoveries—is deeply flawed because it opens the door to wide-ranging discovery and thereby makes it impossible for an aggrieved party to seek a truly objective measure of damages.<sup>39</sup>

### A. *Liquidated Damages*

As a condition of enforceability, the Code requires liquidated-damages provisions to be evaluated *ex post* to ensure that they are “reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or non-feasibility of otherwise obtaining an adequate remedy.”<sup>40</sup> This scrutiny suggests that only liquidated-damages provisions motivated by the difficulty of measuring damages are legitimate, while those intended to function as a penalty or even as an earnest of performance are not.

Recognizing the secrecy interest, however, suggests a reason, wholly apart from coercion or lack of sophistication, that transactors would benefit from entering into a liquidated-damages provision (even a highly undercompensatory provision) that would be summarily enforced. The

---

39. *But see* James J. White, *The Decline of the Contract Market Damage Model*, 11 U. ARK. LITTLE ROCK L.J. 1, 19 (1988-1989) (supporting the expansion of actual-damages caps as a desirable and “modest proposal”).

40. U.C.C. § 2-718(1) (1998).

inclusion of such a provision would enable them to secure compensation without revealing as much firm-specific information as they would have to reveal *ex post* if the contract were breached and expectation damages sought.<sup>41</sup> When the inclusion of a liquidated-damages provision is motivated by the secrecy interest, the Code's *ex post* scrutiny greatly reduces, and in some instances eliminates, the benefits of the provision. The type of information that a defendant is permitted to discover to substantiate a claim that a liquidated-damages provision is invalid is exactly the same information (and perhaps a bit more) that he would be entitled to obtain had the plaintiff sought expectation damages. The secrecy interest therefore provides another reason that such provisions should be summarily enforced, at least in transactions between informed transactors.

Once the effect of information revelation on the aggrieved party's incentive to sue is taken into account, it becomes clear that in a hypothetical jurisdiction that permitted the summary enforcement of liquidated-damages provisions, an aggrieved party's expected recovery under a contract with even an undercompensatory liquidated-damages provision might be greater than the expected recovery of an aggrieved party who had both a significant secrecy interest and a legal right to fully compensatory expectation damages.

It is, however, important to note that liquidated-damages provisions that are included to protect one or both of the transactors' secrecy interests are less likely to be bargained around than are liquidated-damages provisions motivated by the difficulty of proving loss. The process of bargaining may itself reveal information. As a consequence, if such provisions are set too high, they are more likely to lead to inefficiently high levels of contractual performance than are liquidated-damages provisions included for other reasons. However, this efficiency loss needs to be compared to the offsetting efficiency gain that results from the potential relationship-preserving effect of such provisions. The use of a liquidated-damages provision decreases the likelihood that a repeat-dealing relationship, with its associated relationship-specific efficiency gains, will end if a dispute arises.

---

41. The process of negotiating liquidated-damages clauses generally reveals less private information than the discovery process in a suit for expectation damages. First, even liquidated-damages provisions that accurately reveal the magnitude of the aggrieved party's expectation interest do not reveal the underlying information on which it is based, such as detailed cost and profit data or other potentially valuable qualitative information such as the aggrieved party's inventory methods, the identity of her buyers, and the identity of and terms offered by other suppliers. Second, in light of considerations discussed in the text, *see supra* text accompanying notes 29-31, any liquidated-damages amount proposed by a promisee would likely be viewed by a promisor as an unreliable signal of the true quantitative interest of the promisee. Nevertheless, it is important to note that while the secrecy cost of entering into a liquidated-damages provision is less than the secrecy cost of litigating expectation damages *ex post*, the latter cost need be borne only if the relationship between the transactors breaks down, while the former cost is borne with certainty. However, because in the absence of the clause the potential aggrieved party has no credible threat to sue, the likelihood that breach will occur is substantially higher.

Because the dispute will not require either party to reveal its reservation price, the parties at least have the opportunity to resume dealing on their former terms. Moreover, because liquidated-damages provisions are paid for ex ante by the promisee in the form of higher prices, the efficiency loss from overdeterred breaches is likely to be small. Promisees are unlikely to attempt to purchase more "insurance" than is necessary to protect their interests.<sup>42</sup>

### B. *Specific Performance*

The Code permits the award of specific performance when "the goods are unique or in other proper circumstances."<sup>43</sup> Although this standard is more generous than the common-law standard,<sup>44</sup> specific performance for breach of contract remains an uncommon remedy.<sup>45</sup>

The Code's approach to specific performance is similar to its approach to liquidated damages in that both are considered proper only when there is a problem verifying the magnitude of the generally preferred expectation remedy, either because the valuation required is highly subjective and runs a high risk of being undercompensatory (as in the case of valuing a family heirloom with sentimental value) or because it is difficult for a court to administer since the aggrieved party's losses are difficult or expensive for a court to calculate.<sup>46</sup> Recognizing the secrecy interest, however, suggests that a breached-against party might seek specific performance, or transactors might include specific-performance provisions in their contracts, simply to avoid the revelation of private information if a dispute were to arise. When specific performance is sought to protect a secrecy interest, it is desirable not because expectation damages are inaccurate or inadequate, but rather precisely because they are quite accurate and most likely adequate.

When transactors opt for specific performance to protect a secrecy interest, however, the remedy is less likely to be bargained around than when it is sought for the reasons traditionally recognized in the literature.

42. See Bebachuk & Shavell, *supra* note 3, at 298-300 (demonstrating that transactors will never find it desirable to purchase overcompensatory liquidated-damages provisions).

43. U.C.C. § 2-716(1) (1998).

44. See *id.* § 2-716 cmt. 1 ("[T]his Article seeks to further a more liberal attitude than some courts have shown in connection with the specific performance of contracts of sale.").

45. The proposed Code, however, expands the availability of specific performance. See *id.* § 2-807 cmts. 2, 5 (Proposed Revisions 1999) ("[T]his section recognizes and encourages the court to enter a specific performance remedy when the parties have agreed to that remedy," but "[n]othing in this section constrains the court's exercise of its equitable discretion in deciding whether to enter a decree for specific performance.").

46. See ALAN SCHWARTZ & ROBERT E. SCOTT, *COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES* 401 (2d ed. 1991) ("[A] buyer will sue for specific performance only when she believes that her remedy at law would be inadequate: cover and market damages would be unsatisfactory because the buyer thinks that there are no good substitutes for the seller's performance, and a suit for lost profits would be unsuccessful.").

Although bargaining around an order of specific performance may reveal some information, unlike the information needed to calculate the expectation measure (which reveals the precise value the aggrieved party attaches to performance), the information revealed in bargaining around an order of specific performance is a much noisier signal of her true valuation because it reflects both her actual subjective valuation and the bargaining premium that she extracts from the breaching party. This premium, in turn, depends on the breaching party's benefit from breach and the transactors' relative bargaining strengths. Furthermore, even when bargaining around an order of specific performance reveals some information about the magnitude of the aggrieved party's actual loss, it may at least partially protect her secrecy interest because it does not require her to reveal any qualitative business information. Nevertheless, because where a secrecy interest is sufficiently strong, an order of specific performance is less likely to be bargained around than it would be in the absence of the interest, the use of specific performance to protect a secrecy interest may result in some deadweight losses from excessively high levels of contractual performance. These losses should, however, be balanced against the welfare gain from the availability of a secrecy-preserving remedy that maintains the credibility of the aggrieved party's threat to sue and thereby deters inefficient breaches.<sup>47</sup>

### C. *Capping Contract-Market Damages*

The Code gives aggrieved parties the right to recover the contract-market differential plus certain statutorily specified incidental and consequential damages. Recently, however, courts have begun to impose an actual-damages cap on sellers' recovery of the contract-market differential, and a few courts have, under specified circumstances, imposed actual-damages caps on buyers' recovery of contract-market damages as well. This approach is also at the heart of the remedial structure of the proposed Code, which explicitly imposes an actual-loss cap on all damage assessments made under its more particular provisions. Like the courts that have imposed actual-loss caps under the existing Code, the Drafting

---

47. In general, it has been demonstrated that when bargaining is imperfect and negotiations might fail due to asymmetric information, the desirability of specific performance (a property rule) as compared to expectation damages (a liability rule) is diminished. For a general articulation of this claim, see Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 HARV. L. REV. 715 (1996), which argues that when bargaining is imperfect, liability rules are superior to property rules because they lead to more efficient outcomes in situations in which bargaining breakdown in fact occurs. However, it is important to note that in contracting contexts in which secrecy is important, this result will hold if the liability rule selected is an objective rule, but is more questionable if a subjective measure is used, since this in turn may affect the likelihood that suit would be brought.

Committee justified its approach as being necessary to protect the compensatory interest embedded in the existing Code's exhortation that remedies be "liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed."<sup>48</sup>

Although the imposition of such caps has been lauded by leading commentators,<sup>49</sup> the secrecy interest suggests that actual-damages caps are undesirable. The mere availability of such caps gives the breaching party the right to obtain additional potentially valuable information through discovery. As a consequence, even if such caps are in fact rarely imposed (the situation under the existing Code), the ability of the defendant to obtain the discovery necessary to establish whether they are warranted will jeopardize the plaintiff's secrecy interest in a broad range of cases and might either undermine or completely eliminate the credibility of her threat to sue.

In order to illustrate the importance of recognizing the secrecy interest to the desirability of imposing actual-damages limitations, it is useful to look at the relevant Code and proposed Code sections as well as the cases that have led courts and commentators to endorse this approach. Ironically, some leading cases endorsing actual-damages caps are, particularly on the buyer's side, ones in which a substantial secrecy interest may well have been present.

### 1. *Sellers' Remedies*

Courts imposing an actual-damages cap on sellers' right to contract-market damages have drawn on a section of the Code that states that when the contract-market differential is *inadequate*, the seller may instead recover his lost profits.<sup>50</sup> Traditionally, this section has been interpreted to apply only to lost-volume sellers who would be undercompensated by the

---

48. U.C.C. § 1-106(1) (1998).

49. See White, *supra* note 39, at 8, 16 (praising cases imposing actual-loss caps despite the fact that as a matter of statutory interpretation they represent "a large step beyond the Code's explicit limitations upon the use of the market model," and suggesting that "it is time to question the routine acceptance of the market formula" in regular cases); see also *id.* at 3 ("When we claim that a plaintiff's true loss is equal to the market formula difference, we are confusing metaphor for reality. . . . The market formula should be rejected as a model where it produces too great or too little recovery.").

50. The Code states:

If the measure of damages . . . is inadequate to put the seller in as good a position as performance would have done then the measure of the damage is the profit (including reasonable overhead) which the seller would have made from full performance by the buyer, together with any incidental damages . . . , due allowance for costs reasonably incurred and due credit for payments or proceeds of resale.

U.C.C. § 2-708(2) (1998).

contract-market differential.<sup>51</sup> Recently, however, a few courts have held that a buyer may invoke this section to limit a seller's damages to his actual lost profit in situations in which contract-market damages would *overcompensate* the seller.

One of the leading cases in this area is *Nobs Chemical, U.S.A. v. Koppers Co.*<sup>52</sup> In *Nobs*, the plaintiff arranged to purchase a fuel additive from a supplier (under a requirements contract) for \$445 per ton, and contracted to sell 1000 tons of the additive to Koppers for \$540 per ton. Koppers breached the contract. Nobs reduced its purchases under the requirements contract and sued Koppers for contract-market damages. Because the market had significantly declined, the contract-market differential could have been as high as \$320,000, while actual lost profit, calculated on the basis of the \$95 profit per ton, would have been only \$95,000. The court limited Nobs's recovery to its lost profit, explaining that the remedial goal of full compensation—as articulated in the Code and as reflected in Texas case law—was a “strong factor weighing against” the award of contract-market damages.<sup>53</sup> The court held that the Code provision permitting a lost profit measure to be used when the contract-market differential was inadequate applied equally to situations where the measure was either over- or undercompensatory.<sup>54</sup>

In the context described in *Nobs*, however, an aggrieved seller may have a secrecy interest in keeping the information necessary to determine his actual loss private. In particular, a seller may not want a buyer to know his source of supply and whether he is a middleman, a true supplier, or both. Supporters of imposing an actual-damages cap, however, think that this is precisely the type of information that should be used to determine whether the cap should be applied in a particular case. Indeed, White and Summers, two leading proponents of actual-loss caps, “caution courts to

---

51. A plaintiff with a secrecy interest may also be reluctant to claim lost-volume seller status because establishing her lost-volume status will require her to reveal detailed information about her cost structure. See *R.E. Davis Chem. Corp. v. Diasonics, Inc.*, 826 F.2d 678, 684 (7th Cir. 1987) (holding that a plaintiff seeking to establish itself as a lost-volume seller must show “not only that it had the capacity to produce the breached unit in addition to the unit resold, but also that it would have been profitable for it to have produced and sold both units”).

52. 616 F.2d 212 (5th Cir.), *reh'g denied*, 618 F.2d 1389 (5th Cir. 1980); see also *Union Carbide Corp. v. Consumers Power Co.*, 636 F. Supp. 1498, 1501 (E.D. Mich. 1986) (imposing an actual-loss cap on a claim for contract-market damages, explaining that “‘inadequate’ should be interpreted to mean incapable or inadequate to accomplish the stated purpose of the UCC remedies of compensating the aggrieved person but not overcompensating that person or specially punishing the other person”).

53. *Nobs*, 616 F.2d at 215-16.

54. This interpretation of the “inadequate” language in 2-708(2), see *supra* note 50, is endorsed by 1 JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE* 394 (4th ed. 1995): “[T]he defendant should be permitted to restrict the plaintiff to . . . [an actual damages limitation] in those circumstances in which the defendant buyer can show that . . . [the award of the contract-market differential] will overcompensate the plaintiff.”



analyze all the circumstances surrounding the transaction”<sup>55</sup> before making such a determination. If such an approach were adopted, however, the contract-market differential would be transformed into a subjective measure of damages that, even under a more restrictive discovery regime, could not be used to provide a safe harbor to transactors who wished to protect private information.

## 2. *Buyers' Remedies*

Most courts do not impose an actual-loss cap on buyers' right to obtain contract-market damages. Recently, however, some courts have begun to impose such a limitation, primarily in situations involving middleman buyers who have contracted to buy goods and resell them to an identified buyer. Curiously, these are situations in which the aggrieved party's secrecy interest is likely to be particularly strong.

In the first case, *Allied Cannery & Packers, Inc. v. Victor Packing Co.*,<sup>56</sup> an aggrieved middleman buyer sought contract-market damages for breach of a contract to deliver raisins. The court, however, limited his recovery to the profit he would have made under his existing resale contract. The court explained that because a flood had damaged the relevant raisin crop, legally excusing the middleman from his obligations to his identified buyer under the doctrine of *force majeure*, awarding his lost resale profit would be fully compensatory and would prevent him from obtaining a windfall under the contract-market measure.<sup>57</sup> Curiously, the *Allied* court explicitly recognized the middleman buyer's secrecy interest, noting that it was the practice of the government raisin authority, which played a role in the administration of these contracts, to “keep[ ] the name of the foreign importer [the middleman's buyer] confidential, as frequently the exporter, in order to protect his business sources, does not want the packer [the original seller] to have that information.”<sup>58</sup> Yet, in order to apply the court's criteria for deciding whether an actual-loss cap should be imposed, and, if so, what the resale profit would have been, this is precisely

---

55. 1 *id.* at 398. In addition, in discussing *Trans World Metals, Inc. v. Southwire Co.*, 769 F.2d 902 (2d Cir. 1985), a leading case that refuses to impose an actual-loss cap on sellers' damages, White and Summers explain that they cannot take a definitive position on the wisdom of the holding, because the information they would need to determine if the case was rightly decided—such as “whether the seller is a manufacturer or merely a middleman . . . [and] what arrangements the seller had with upstream suppliers”—was unavailable. 1 WHITE & SUMMERS, *supra* note 54, at 397. This, however, is precisely the sort of information that an aggrieved party with a secrecy interest would want to keep private.

56. 209 Cal. Rptr. 60 (Ct. App. 1984).

57. Making a seller's liability for breach turn on whether a buyer has a contract for resale may encourage a seller to breach a contract with a buyer in order to get this information and sell directly to the buyer's customer in the future.

58. *Allied*, 209 Cal. Rptr. at 61.

the information that the aggrieved party would have to reveal during discovery.

In the other leading case, *H-W-H Cattle Co. v. Schroeder*,<sup>59</sup> the court capped a middleman cattle broker's damages at the amount he would have realized on resale, explaining that the award of contract-market damages would give the plaintiff a "windfall" and would "violate the general principle concerning remedies underlying Article 2 of the Uniform Commercial Code."<sup>60</sup> Although the middleman explained that his true damages would be higher since he would be liable for breaching his contract with his end-purchaser, the court rejected this argument, noting that because the end-purchaser had not demanded performance or sued, it was improper to take this into account.

The willingness of courts to impose actual-loss caps on aggrieved middleman buyers is particularly curious since middleman buyers tend to have extraordinarily strong secrecy interests. If a middleman's supplier learns the terms on which the middleman sells to her customers, the supplier will have a good idea of her reservation price and may be able to extract a far higher portion of the middleman's consumer surplus than it would without the information. In addition, in markets where sellers engage in both direct and middleman or broker-mediated sales, there is nothing to stop the seller from selling directly to the middleman's customers once their identity (and the price they are willing to pay) is revealed.<sup>61</sup> A middleman's customer list is a valuable business asset.

Moreover, the doctrines articulated in these cases require a determination of how a seller's breach affected contracts that the aggrieved buyer had with third parties. In making this determination, however, courts have ignored important relational elements of these exchanges. In *Allied*, for example, the court noted that the middleman's identified buyer "demanded delivery," but held that because the middleman's obligation to deliver under its contract with its buyer was excused by the doctrine of *force majeure* and the buyer never sued, no damages were suffered by the middleman as a result of breach.<sup>62</sup> However, the fact that legal liability was

---

59. 767 F.2d 437 (8th Cir. 1985).

60. *Id.* at 439-40.

61. The holdings in *Allied* and *H-W-H* may also have disproportionately bad effects on smaller middlemen, who are more likely to identify goods to a contract, as compared to larger middlemen who may have larger inventories or a greater number of suppliers and buyers and who therefore are more likely to be awarded contract-market damages.

62. The mere fact that a party is legally excused from performance does not mean that nonperformance is costless. For example, most grain contracts have generous *force majeure* provisions, yet grain merchants are extraordinarily reluctant to invoke them. In the mid-1990s, large portions of the Mississippi River froze and halted barge traffic. Nevertheless, most sellers, with the notable exception of one large company, did not avail themselves of the excuse. The one company that declared *force majeure* and used it as an excuse not to deliver found that many people in the market would no longer do barge-related business with it and the firm's

not incurred does not mean that harm was not suffered. Indeed, in *Allied*, the middleman buyer testified at trial that "it had suffered additional consequential damages through the loss of the entire account"<sup>63</sup> with its buyer. Similarly, in *H-W-H*, the court recognized the unusual fact that the middleman and the end user were owned by the same parent company. It did not, however, consider the possibility that this relationship, rather than the absence of a true loss, might well account for the fact that performance was not demanded and suit was not filed.

In sum, although cases imposing actual-loss caps have generally been lauded by commentators,<sup>64</sup> while those that have refused to impose such limitations<sup>65</sup> have generally been criticized in the commercial law literature,<sup>66</sup> recognizing the secrecy interest suggests an additional reason why actual-loss caps, even when sparingly imposed by courts, are undesirable.

### 3. *The New Remedial Hierarchy in the Proposed Code*

The remedial hierarchy in the proposed Code includes a wide-ranging actual-damages limitation. Its official comments explicitly reject the logic of the cases refusing to impose actual-loss caps and transform the compensation principle into an overarching principle of damages calculation. As the official comment to the section of the proposed Code that embodies the full compensation principle of the existing Code states, this section "sets forth remedial policies that control the applications of *the*

---

representatives were widely ridiculed at the next year's trade meeting. See Interview with Grain Industry Executive (1995).

63. *Allied*, 209 Cal. Rptr. at 66 n.8.

64. See 1 WHITE & SUMMERS, *supra* note 54, at 394 ("We are at least tentatively persuaded that *Allied* and *H-W-H* should be followed, but that Courts should take care to apply . . . [both] narrowly."). See generally White, *supra* note 39 (endorsing the outcome in these cases).

65. The leading case refusing to impose an actual-damages limitation is *Tongish v. Thomas*, 829 P.2d 916, 919 (Kan. Ct. App. 1992), in which the court refused to use the general language of section 1-106 to impose an actual-loss cap, explaining that "[w]hen there is a conflict between a statute dealing generally with a subject and another statute dealing specifically with a certain phase of it, the specific statute controls unless it appears that the legislature intended to make the general act controlling."

66. See, e.g., Roy Ryden Anderson, *Damage Remedies Under the Emerging Article 2—An Essay Against Freedom*, 34 HOUS. L. REV. 1065, 1109 (1997) (critiquing the holding in *Tongish* as "read[ing] section 1-106 entirely out of the Code"); Michael T. Gibson, *Reliance Damages in the Law of Sales Under Article 2 of the Uniform Commercial Code*, 29 ARIZ. ST. L.J. 909, 924 n.70 (1997) (suggesting that U.C.C. § 1-106's protection of the expectation interest is a mandatory rule and that *Tongish* was wrongly decided because the court "ignored section 1-102's command to use its purposes when interpreting more 'specific' Code sections, a command which overrides the traditional rule" of statutory interpretation). But see David W. Carroll, *A Little Essay in Partial Defense of the Contract-Market Differential as a Remedy for Buyers*, 57 S. CAL. L. REV. 667, 668 (1984) (defending the contract-market measure on the grounds that in almost all instances it provides an accurate compensatory remedy).

*more specific remedial rules,”*<sup>67</sup> which set out the buyer’s and seller’s remedies.

By elevating the compensatory interest to an overriding principle of damage calculation, the proposed Code opens up virtually all remedies to a defendant’s claim that a particular plaintiff’s recovery would be overcompensatory and thus should be reduced.<sup>68</sup> It thereby transforms contract-market damages from an objective remedy that might be invoked to protect an aggrieved party’s secrecy interest into a subjective remedy that permits a breaching party to obtain wide-ranging firm-specific information during the discovery process.

The proposed Code also eliminates the imperfect yet significant secrecy benefits of seeking restitution damages. As the official comments note, “An aggrieved party should not be able to . . . recover damages based upon its reliance or restitutionary interests when those interests are greater than its expectancy interest.”<sup>69</sup> Because this limitation entitles the defendant to obtain the information necessary to calculate expectation damages, it has the same effect on the aggrieved party’s litigation choices as an actual-loss cap. It therefore transforms restitution damages into a subjective damage measure and would make it even more difficult to transform reliance damages into a quasi-objective remedy.

#### D. Cover

The Code provisions and common-law doctrines relating to cover are among the least criticized principles of contract remedies. Under the Code, an aggrieved buyer is forced to make an election of remedies. She can cover—that is, buy substitute goods, and seek damages in an amount equal to the contract-cover differential plus incidental damages “less expenses

---

67. U.C.C. § 2-801 cmt. 2 (Proposed Revisions 1999) (emphasis added); *see also id.* § 2-803 cmt. 3 (“The specific remedies . . . are designed to compensate the aggrieved party based upon its expectation interest.”). This language squarely rejects the logic used in cases refusing to impose a cap such as *Tongish*. *See also* Memorandum from Richard E. Speidel to Article 2 Drafting Committee, ALI Sales Subgroup (Mar. 1, 1997) (on file with the authors) (strongly suggesting that preventing ex post overcompensation is a major goal of the revision). The move toward limiting damages to an aggrieved party’s actual loss was even more unmistakably expressed in earlier drafts of the Proposed Code. *See* U.C.C. § 2-803(c) (Discussion Draft Apr. 14, 1997) (“[A] court may deny or limit a remedy if, under the circumstances, it would put the aggrieved party in a substantially better position than if the breaching party had fully performed.”).

68. The proposed Code’s provision on consequential damages gives the breaching party an additional ground on which to challenge the magnitude of the aggrieved party’s damages, thereby even further broadening the information the breaching party is entitled to obtain. *See* U.C.C. § 2-806 cmt. 4 (Proposed Revisions 1999) (providing that it is proper “to limit consequential damages if under the circumstances ‘justice so requires in order to avoid disproportionate compensation’” (citations omitted)).

69. *Id.* § 2-804 cmt. 3.

saved in consequence of the seller's breach"<sup>70</sup>—or she can seek contract-market damages<sup>71</sup> plus certain incidental and consequential damages.<sup>72</sup>

Whether a plaintiff has adequately covered is a question of fact.<sup>73</sup> In cases in which an aggrieved buyer has in fact covered, proving that she did so in an appropriate manner requires her to reveal a great deal of private information. Establishing whether cover has taken place necessitates an inquiry into many of the transactions that the aggrieved party entered into immediately following breach. It may also require her to reveal sensitive business or market information,<sup>74</sup> the identity of the next lowest cost supplier and the price at which he is willing to sell, as well as the identity and price charged by a large number of other market participants.<sup>75</sup> Indeed, White and Summers advise a breached-against buyer to "build a record that shows he made reasonable inquiries of alternative sources of supply before making his cover purchases."<sup>76</sup> This, however, is precisely the type of information that the aggrieved party would prefer to keep private, since it might well reveal her reservation price.

It is also important to note that even when the aggrieved party elects not to cover, the Code provision on cover might jeopardize the aggrieved party's secrecy interest, albeit to a lesser extent. In such a situation, the breaching party, in an attempt to limit his damages, still has the right to inquire into the extent of the aggrieved party's search for cover and to attempt to demonstrate that the aggrieved party in fact covered. And, in an

70. U.C.C. § 2-712(2) (1998).

71. *See id.* § 2-713.

72. *See id.* § 2-715. The Code's official comments make it clear that the contract-market measure is "completely alternative to cover . . . and applies only when and to the extent that the buyer has not covered." *Id.* § 2-713 cmt. 5. The exclusivity of the cover remedy was, after a lengthy debate, explicitly endorsed in the proposed Code. *See* U.C.C. § 2-803 cmt. 4 (Proposed Revisions 1999).

73. *See Transammonia Export Corp. v. Conserv, Inc.*, 554 F.2d 719, 724 (5th Cir. 1977) ("[W]hether a plaintiff has made his cover purchases in a reasonable manner poses a 'classic jury issue'").

74. This is particularly true since the Staggers Act of 1980 deregulated rail tariffs. *See* Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895. Buyers of cash commodities, for example, often negotiate secret rate discounts with Railroads. *See* Interview with Grain Merchant (1998). In contracts in which the buyer pays the freight, if the seller knew the content of these special deals, he might be able to extract more of the buyer's consumer surplus. These rate agreements tend to be for months at a time, so revealing them could be quite costly. Because a plaintiff's recovery of the contract-cover differential is reduced by costs saved in consequence of a seller's breach and transportation costs are one of the most common costs saved, *see* Michael F. Quinn, *Remedies*, in *BASIC U.C.C. SKILLS* 1989: ARTICLE 2, at 41, 78 (PLI Commercial & Practice Course Handbook Series No. 502, 1989), a seller would likely seek discovery of these and related costs.

75. She might also be required to reveal how wide her search of the relevant market was. *See Productora e Importadora de Papel S.A. de C.V. v. Fleming*, 383 N.E.2d 1129, 1137-38 (Mass. 1978) (holding that it was error for the court below to exclude evidence of whether, in addition to its "regular suppliers," other major brokers in the industry were contacted to try to procure cover).

76. 1 WHITE & SUMMERS, *supra* note 54, at 288.

effort to establish this claim, he has the right to obtain discovery on many aspects of the breached-against party's business—among them the identity of her other suppliers, the quantities she bought from each in the relevant period together with the price paid, and the amount of inventory she typically carried.<sup>77</sup> The mere availability of the cover remedy may therefore discourage an aggrieved party from filing suit to recover even the objective contract-market differential, even though measuring the contract-market differential itself does not require the revelation of information.

### E. *Mitigation*

Although the doctrine of mitigation has also escaped serious criticism,<sup>78</sup> it too may jeopardize the aggrieved party's secrecy interest. A defendant attempting to establish that a plaintiff failed to mitigate her damages is permitted to take broad discovery of numerous documents and information that plaintiffs often have a substantial interest in keeping private. As a leading treatise on the recovery of damages for lost profit explains, a defendant's first round of interrogatories related to mitigation should demand that the plaintiff

[i]dentify each and every source of income derived by you during the period of time you claim or contend that you suffered the damages alleged. As to each source of income, include in your answer: (a) Whether the income was derived pursuant to a written contract, and, if so, the name and address of the custodian of the contract; (b) Whether the income was derived pursuant to an oral

---

77. This problem is likely to be particularly acute in situations in which the aggrieved buyers purchase from many sellers. Because an aggrieved buyer may call a purchase of a particular lot "cover" or "not cover," a defendant-seller attempting to rebut this assertion would likely have access to the buyer's internal allocation, accounting, and inventory systems, all of which may contain valuable information about her vulnerability to holdup. *See, e.g., Coast Trading Co. v. Cudahy Co.*, 592 F.2d 1074, 1081-82 (9th Cir. 1979) (noting, in a dispute as to whether the seller's ability to elect damages based on the resale-contract differential was capped by the seller's actual loss, that information about the identity of those the seller resold to around the date of resale, the name of its purchasers, the price, and the amount sold had been introduced into the record at trial). In addition, Michael Quinn notes,

If buyer purchases the same goods from many sellers on a regular basis and one seller breaches, it may be difficult to ascertain which subsequent contract buyer entered into to purchase goods in substitution for the goods which the seller failed to supply. . . . If the matter proceeds to litigation, seller is well advised to make sure he discovers information relating to all of buyer's post-breach purchases. Hopefully, he will be able to uncover a purchase by buyer at or near the contract price which occurred soon after the seller's breach which he can argue is the cover purchase from which damages must be measured.

Quinn, *supra* note 74, at 75-76.

78. *See* Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 967 (1983) ("The duty to mitigate is a universally accepted principle of contract law requiring that each party exert reasonable efforts to minimize losses whenever intervening events impede contractual objectives.").

contract, and, if so, the terms and conditions of the oral contract; (c) The amount of income derived; (d) The date or dates such income was derived; and (e) The nature of the services rendered by him as consideration for the income, and the dates during which the services were performed.<sup>79</sup>

Since the duty to mitigate applies to all contractual relationships and exists even where the breached-against party has elected not to cover,<sup>80</sup> it, too, may greatly undermine the credibility of an aggrieved party's threat to sue. This suggests that in a regime in which truly objective damages were available, it would be desirable either to eliminate the duty to mitigate or to give summary enforcement to contract clauses waiving the duty. Unlike in a regime of subjective damages where eliminating the duty might lead to suboptimal amounts of actual mitigation, in a regime of objective damages, such a change will not lead to suboptimal amounts of mitigation, and might even lead to more efficient mitigation.<sup>81</sup> When an aggrieved party knows that her recoverable damages will be limited to the objectively determined amount and will not be reduced if actual losses are avoided or increased if additional losses are incurred, she will have the optimal incentive to mitigate. Because the aggrieved party gets the full benefit of any losses she avoids and bears the full cost of taking actions to avoid losses, she will only take actions in mitigation whose costs are less than their benefits, precisely the actions that it is efficient for her to take.

#### F. *Other Doctrines and Concerns*

Although this Essay has focused on the ways that recognizing the secrecy interest affects the desirability of various Code and common-law

---

79. 2 ROBERT L. DUNN, *RECOVERY OF DAMAGES FOR LOST PROFITS* 718 (5th ed. 1998). In addition, practice manuals suggest that a manufacturer-plaintiff's fixed costs—which may include “such items as materials purchased for use on a number of products or production units, costs of energy or other plant operation expenses . . . that can be reallocated, and wages or salaries of personnel whose labor can be relocated”—should be “searched out and identified,” by a defendant attempting to show lack of mitigation. Richard C. Tinney, *Reduction or Mitigation of Damages: Sales Contract*, in 11 AM. JUR. PROOF OF FACTS 2D 131, 245 (1976).

80. For a discussion of when a failure to cover is considered to be a failure to mitigate losses, see 1 WHITE & SUMMERS, *supra* note 54, and sources cited therein.

81. A subjective damage measure with a duty to mitigate may lead to less mitigation than would an objective measure with no duty to mitigate. In practice, courts construing the contours of the duty to mitigate are generous to the aggrieved party. As a consequence, an aggrieved party knows that if her losses increase because she failed to take certain steps in mitigation, she may well be compensated for these losses. In contrast, under an objective damage rule with no mitigation requirement, she knows she will bear the full cost of any losses not avoided. See Robert Cooter, *Unity in Tort, Contract and Property: The Model of Precaution*, 73 CAL. L. REV. 1, 15 (1985) (demonstrating that damages calculated on the basis of the contract-market differential provide the promisee with efficient incentives to rely and to mitigate damages); Epstein, *supra* note 38, at 134.

remedial provisions, it also has implications for a number of other doctrines. Because some of these doctrines require the revelation of private information and impose essentially nonwaivable constraints on transactors, recognizing the secrecy interest suggests additional considerations that ought to be taken into account in evaluating the desirability of these doctrines.

One such doctrine is substantial performance. Once a defendant is entitled to the information to establish whether or not a breach is material, the plaintiff's secrecy interest is seriously jeopardized. Similar problems arise in the Code's approach to nonconforming tender. The Code has technically preserved the perfect-tender rule.<sup>82</sup> However, when the tender provisions are read together with other Code provisions, it is generally recognized that something closer to the doctrine of substantial performance with a price adjustment is the dominant rule.<sup>83</sup> As a consequence, in contracting contexts in which the revelation of the information needed to impose the appropriate price adjustment threatens to undermine the aggrieved party's secrecy interest, recognizing the existence of the interest suggests that greater adherence to the perfect-tender rule might be advisable.<sup>84</sup>

It is also important to consider the effects of the Code provision giving contracting parties the right to demand adequate assurances of performance and to treat a contract as repudiated if the assurances are not forthcoming.<sup>85</sup> In certain contexts, this provision actually heightens the importance of the breaching party's and/or the aggrieved party's secrecy interests. Consider,

---

82. See U.C.C. § 2-601 (1998) (providing that the buyer may reject goods if "the goods or the tender of delivery fail in any respect to conform to the contract").

83. See 1 WHITE & SUMMERS, *supra* note 54, at 439-45 (discussing the Code's tender-related provisions and concluding that "the cases decided to date suggest, that the Code changes [from the common law] and the courts' manipulation have so eroded the perfect tender rule that the law would be little changed if [the Code] gave the right to reject only upon 'substantial' nonconformity").

84. This problem is also present to an even greater extent in the Code provision on installment sales, U.C.C. § 2-612 (1998).

85. See *id.* § 2-609. The goal of U.C.C. § 2-609 is to help promisees maintain the level of financial risk they assumed when they entered into a contract. As the official comment explains,

[T]he section rests on the recognition of the fact that the essential purpose of a contract between commercial men is actual performance and they do not bargain merely for a promise or for a promise plus the right to win a lawsuit and that a continuing sense of reliance and security that the promised performance will be forthcoming when due, is an important feature of the bargain.

*Id.* § 2-609 cmt. 2. Recognizing the secrecy interest, however, suggests that while the provision may help promisees protect themselves when a firm's financial position declines, it may also have the effect of discouraging firms from bringing lawsuits with a positive expected return, even though doing so makes the firm's promisees better off by adding money to the corporate coffers. However, when the filing of suit reveals information that will result in the firm facing expensive demands for adequate assurances of performance from nonparties to the suit, see *id.* § 2-609 cmt. 3, such as the posting of bonds and escrows, the entity may choose to forgo the suit since the giving of the assurances is so costly, thereby reducing the pool of assets available to satisfy the firm's creditors.



for example, a quality-related dispute between a seller of a component part and a buyer who uses that part to manufacture a complex good. In such a situation, a buyer who files suit and reveals the problem during discovery might immediately face Code-justified demands for adequate assurances of performance from suppliers of other components (who fear that delay in getting the assembled product to market may result in buyer-side financial distress) and from any people who placed orders for the product the buyer was manufacturing. The official comments to this section explain that "a ground for insecurity need not arise from or be directly related to the contract in question."<sup>86</sup> As a consequence, the potential secrecy-related cost of the right to demand these assurances is likely to be significant, because the higher the aggrieved party asserts its damages to be, the more legitimate are the demands others might make of it for adequate assurances. In addition, the seller may also have a secrecy interest in keeping quality-related information from the market. As the official comments explain, "[A] buyer who requires precision parts which he intends to use immediately upon delivery, may have reasonable grounds for insecurity if he discovers that his seller is making defective deliveries to other buyers with similar needs."<sup>87</sup> This suggests that a seller may face demands for assurances from other buyers if quality-related information is revealed during a dispute.

The Code is rather vague as to what constitutes adequate assurances, but it appears to give the party giving the assurances the right to determine the form they should take. According to a leading commentator, however,

[i]n practice . . . the courts tend to view the demand made by the promisee as the focal point for considering adequacy, and a promisor is ill-counseled to vary the assurance demanded if it does not exceed the minimum kind of guarantee necessary to relieve the promisee's anxiety concerning performance.<sup>88</sup>

Common types of assurances include "accommodation notes, escrow accounts, or proof that the buyer's financial condition is not as bad as suspected."<sup>89</sup> Whether a particular response is adequate in a given situation depends strongly on the financial position of the person giving the assurances and the details of the business operations of the person receiving

---

86. *Id.* § 2-609 cmt. 3.

87. *Id.* § 2-609 cmt. 2.

88. 2 WILLIAM D. HAWKLAND, *UNIFORM COMMERCIAL CODE SERIES* § 2-609:3 (1998).

89. 2 *id.* The effects of this Code provision are further exacerbated by the requirement that the assurances be given "within a reasonable time not exceeding 30 days." U.C.C. § 2-609(4) (1998).

them. As a consequence, making this determination is likely to require the revelation of a great deal of information.<sup>90</sup>

### G. *Toward a (Potentially) Secrecy-Preserving Remedial Regime*

Broadly speaking, recognizing the ways that an aggrieved party's secrecy interest might affect her contracting and litigation-related behavior in a jurisdiction with liberal rules of discovery suggests that the remedial provisions of the Code are not pure default rules. While transactors can draft provisions that, within certain bounds, affect the magnitude of a damage award, they are manifestly not free to contract for the mix of monetary damages and ex post information revelation that they find desirable. In practice, the scrutiny of liquidated-damages provisions, the tests for specific performance, and the availability of actual-damage caps, as well as the nonwaivable doctrines of cover and mitigation, together with various performance-related doctrines, make the form of the remedy a quasi-mandatory rule and wholly prevent transactors from contracting for an objective measure of damages, even when doing so would leave them both better off.

A legal regime that prevents transactors from contracting for objective damage measures or liquidated damages free of ex post judicial scrutiny, together with the types of broad ranging discovery permitted in most American jurisdictions, leads to significant social costs. Consider a buyer with a secrecy interest who is negotiating with a seller. If the buyer cannot protect her secrecy interest through an objective damage remedy, this will affect the likelihood that the transaction will be consummated as well as the terms and conditions selected. First, if the secrecy interest is large, the buyer might forgo the transaction entirely. The nonavailability of an objective damage measure makes certain types of commitments non-contractible. A manufacturer may, for example, decide to produce certain component parts in-house rather than risk secrecy-compromising lawsuits with her suppliers. Alternatively, she may enter into a staggered series of short-term exchanges rather than a long-term contract with its associated efficiency gains, in order to reduce her vulnerability to any one breach. Second, the buyer may require a price reduction up front to make it worthwhile to take the risk that the seller will breach. Third, other complex and, most likely, excessively costly, contractual arrangements may be employed to attempt to contract around the problems created by these

---

90. "For example, where the buyer can make use of a defective delivery, a mere promise by a seller of good repute that he is giving the matter his attention and that the defect will not be repeated is normally sufficient." U.C.C. § 2-609 cmt 4. Applying this section, however, requires the buyer to reveal whether he can make any use of defective delivery, something he may well want to keep private since revealing it may lead the seller to behave opportunistically.

limitations. Fourth, limitations on the availability of objective damage measures and the inability of transactors to limit discovery may provide a reason for transactors to contract for arbitration,<sup>91</sup> or markets to opt out of the public legal system. Fifth, in situations in which an aggrieved party

---

91. In general, a desire to keep proceedings private is an important reason that transactors opt for alternative dispute resolution (ADR). The press and other members of the public who have wide access to judicial proceedings have no right to attend private ADR proceedings. In fact, advertisements for private ADR providers tend to emphasize secrecy. See Gail Diane Cox, *The Best Judges Money Can Buy*, NAT'L L.J., Dec. 21, 1987, at 1, 24 (stating that, according to the president of Judicate, then a leading ADR provider, "[c]onfidentiality is part of what his firm sells"). The American Arbitration Association (AAA), one of the largest providers of general commercial arbitration services, directs its arbitrators to render a judgment in the form of a nonpublic award that contains no findings of fact or statements of law. See AMERICAN ARBITRATION ASS'N, COMMERCIAL ARBITRATION RULES, R. 42-45 (1993). However, the AAA does recommend that its arbitrators itemize their award of damages if either party so requests, a practice that itself jeopardizes the secrecy interest. See AAA GUIDE FOR COMMERCIAL ARBITRATORS 23 (1999). In addition, nothing prevents a party to an arbitration from sharing what it has learned with other market participants.

Under current law, the extent to which transactors can constrain arbitrators' damages calculations by contract in ways that conflict with the background legal rules is unclear, particularly when these rules are mandatory rather than default, such as the rule that liquidated damages are invalid if they are found to be penalties. See generally IAN R. MACNEIL ET AL., FEDERAL ARBITRATION LAW, ch. 36 (1994). However, judicial review of decisions applying remedies that conflict with the law is quite lax. For example, in *Grayson-Robinson Stores v. Iris Construction Corp.*, 168 N.E.2d 377 (N.Y. 1960), the court upheld an AAA arbitration award ordering specific performance of a construction contract even though in the court's view a court might not have entered such an award. See *id.* at 379-80. The court explained that the AAA rules specifically authorized specific performance so that to overturn their award would "frustrate the whole arbitration process." *Id.* at 379; see also Steven J. Ware, *Default Rules from Mandatory Rules: Privatizing Law Through Arbitration*, 83 MINN. L. REV. 703 (1999) (discussing the extent to which substantive law can be privatized through arbitration).

The extent to which parties can contract to limit discovery in arbitration is also quite unclear, as there are three methods through which information is disclosed in arbitration: "by voluntary exchange, by order of the arbitrators, and, in rare cases, by order of the court directly at the request of a party." MACNEIL ET AL., *supra*, § 34.1. The Federal Arbitration Act, 9 U.S.C. § 7 (1994), and the UNIF. ARBITRATION ACT § 7(a), 7 U.L.A. 199 (1997) both give arbitrators the authority to order discovery on their own initiative if they think it is relevant to the dispute, and many state statutes give them broad rights of discovery as well. See, e.g., GA. CODE ANN. § 9-9-9(b) (Supp. 1999). In addition, at least under the Federal Arbitration Act, courts are reluctant to limit discovery too much. See, e.g., *Chevron Transp. Corp. v. Astro Vencedor Compania Naviera*, 300 F. Supp. 179, 181 (S.D.N.Y. 1969) (holding that where one party had limited access to some documents, the fact that the Federal Arbitration Act did not set out specific discovery rules did "not negate the affirmative duty of arbitrators to insure that relevant documentary evidence in the hands of one party is fully and timely made available to the other side before the hearing is closed"). For an overview of federal law on the subject, with sporadic references to state law, see MACNEIL ET AL., *supra*, ch. 34. Given these limitations, the extent to which parties can get around secrecy-related problems by providing for arbitration in their contract is unclear.

The substantive and procedural rules of industry-specific arbitration tribunals, such as the rules of the Memphis Cotton Exchange, the National Grain and Feed Association, and the American Fats and Oils Association, however, often limit remedies and provide very limited party-initiated discovery. They are able to do this as a practical matter not because it is clearly authorized by the law, but rather because there are reputational considerations that make even losing parties reluctant to challenge the decisions of these tribunals in court. For a discussion of the reputational forces that prevent such challenges in one industry, see Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 138-43 (1992).

knows that she will not find it desirable to sue in the event of breach, she will reduce her relationship-specific reliance investments. Finally, when objective damage remedies are unavailable, transactors may only be willing to do business with people about whose commercial reputation they have good information, or people upon whom they can impose significant nonlegal sanctions in the event of breach. This is likely to lead to each transactor having a suboptimal number of trading partners.

The existence of these costs suggests an additional reason that the law should be amended to give transactors the ability to opt out of the expectation measure by contracting *ex ante* for either a liquidated-damages provision that will receive no *ex post* scrutiny or a contract-market measure of damages that will be calculated without reference to actual loss,<sup>92</sup> even though, as many courts and commentators have suggested, the contract-market measure serves the goal of full compensation “only by the sheerest of accidents.”<sup>93</sup>

It is also important to note, however, that making truly objective contract-market damages available would also require additional substantive and procedural changes. On the substantive side, it would require making the presence or absence of a cover transaction irrelevant to the right to obtain contract-market damages, eliminating the duty to mitigate, eliminating the right to demand adequate assurances of performance, and perhaps changing certain performance-related obligations. On the procedural side, it would require making damages-related discovery unavailable to a defendant when objective damages are selected. Although such changes might create an increased risk that some aggrieved parties will be overcompensated, recognition of the secrecy interest suggests that this risk needs to be weighed against the currently unrecognized risk of undercompensation created by the availability of subjective damage measures and the liberal rules of civil discovery.

---

92. This reason for maintaining the aggrieved party's right to elect contract-market damages differs from the reasons typically found in the literature:

[A] variety of arguments have been employed by commentators and courts to justify [the contract-market measure]: the desirability of maintaining a uniform rule and of facilitating settlements; the public interest in encouraging contract performance and the proper functioning of the market; the prevention of defendant's unjust enrichment; the restoration of the very “value” promised to the plaintiff; and the inherent difficulty and complexity of proving actual economic losses not encompassed within the contract terms.

David Simon & Gerald A. Novack, *Limiting the Buyer's Market Damages to Lost Profits: A Challenge to the Enforceability of Market Contracts*, 92 HARV. L. REV. 1395, 1403 (1979) (footnotes omitted).

93. Ellen A. Peters, *Remedies for Breach of Contracts Relating to the Sale of Goods Under the Uniform Commercial Code: A Roadmap for Article Two*, 73 YALE L.J. 199, 259 (1963); see also White, *supra* note 39, at 2 & n.6 (“It is now commonplace for commentators and courts to acknowledge that the [contract-market] formula does not put the plaintiff in the same position as performance would have . . .”). But see Carroll, *supra* note 66, at 667-68.

### III. IMPLICATIONS FOR ADJUDICATIVE PROCEDURE

In order to fully understand the implications of recognizing the secrecy interest, it is also important to recognize that the liberal rules of civil discovery in effect in most American jurisdictions are at least partly responsible for the undesirable effects of subjective damage measures. It is therefore useful to explore the ways that discovery rules might be changed, or other adjudicative rules and procedures altered, to alleviate the secrecy-related problems created by the substantive content of commercial law.

#### A. *Delay*

Recognizing the secrecy interest suggests that delay in the litigation process may not be entirely undesirable. Although the time value of money, the natural spoliation of evidence, and the fact that the aggrieved party may not have access to capital on reasonable terms during the pendency of a dispute all make delay detrimental to the aggrieved party, in situations in which her secrecy interest is time-dependent, certain types of delay may be highly advantageous and indeed lead her to obtain a more nearly compensatory recovery than she would if adjudication were immediate.

However, since it is the information revealed during discovery that undermines the secrecy interest, delay in trial is only beneficial if there is a delay in the initiation of the discovery process as well. This suggests that while early discovery may promote settlement by giving the parties a clearer sense of the bargaining range, there are some instances in which delay in the initiation of discovery may be advantageous and may help ensure that any settlement reached more nearly compensates the aggrieved party for her loss.

It is important to note, however, that in situations in which the aggrieved party has access to capital on reasonable terms and the relevant evidence is not too susceptible to spoliation, the undesirable effects of the Code's substantive provisions and the rules governing discovery and disclosure are at least partially offset by the fact that the Code's statute of limitations gives the breached-against party four years from the time of the breach to file suit.<sup>94</sup> Four years may be long enough for most secrecy concerns relating to the underlying transaction to become inconsequential.<sup>95</sup>

---

94. See U.C.C. § 2-725 (1998).

95. However, it is also important to note that because delay also favors the defendant, the effect of using the limitations period is to decrease the breaching party's expected liability (due to the time value of money) and hence to increase his incentive to inefficiently breach.

### B. *Pleading Reform*

One procedural change that would enable a plaintiff to better protect her secrecy interest would be to permit her to limit the types of damages she requests in her pleadings in a way that would limit the type of damages-related information the defendant could obtain through discovery. This is something that it is not possible to do under current law. If such a change were adopted, the message sent by, for example, failing to request lost profits, would be quite difficult to decode. It might mean that the profit to be recovered was small in relation to the value of some industrial information that would be revealed, or it might mean that it was high and the plaintiff did not want to reveal it for fear of having to pay a higher price in future negotiating rounds.

The main substantive obstacles to such a reform, however, are, as discussed earlier, the remedial doctrines of mitigation and cover. Since the burden of proving mitigation or that the plaintiff in fact covered rests on the defendant, he is entitled to get broad discovery about the plaintiff's actions in order to establish these claims.

### C. *Special Masters and Discovery*

In contracting contexts in which a secrecy interest is substantial, it could be at least partially protected and the goal of full compensation more nearly achieved, if transactors could contract in advance for a quasi-inquisitorial procedure in which a designated special master would determine the amount of damages, if any, to be awarded in the event of breach. The special master could be given the authority to obtain the relevant information from each party and to make an award on the basis of this information without making the information itself available to the parties. Although the accuracy benefits of party-conducted cross-examination would be lost and the special master's award would reveal the total magnitude of the aggrieved party's damages, such a procedure would ensure that the content of sensitive business information would not be revealed. It would therefore partially protect a secrecy interest in the components of an aggrieved party's reservation price and more completely protect her interest in other types of proprietary information. Using such a special master to determine damages in an inquisitorial way has several additional benefits. First, if the special master is knowledgeable about the industry, his award may be more accurate than that of a judge or jury. Second, if he is called on to calculate damages only after liability has been established, the general benefits of bifurcation—avoiding the expense of the damages phase not only of trial but also of discovery when liability is not

found—can be obtained.<sup>96</sup> Finally, avoiding party-initiated discovery on the subject of damages is likely to substantially reduce the cost of disputing.

#### D. *Protective Orders*

Another way to partially protect the secrecy interest is to broaden the availability of so-called “lawyers’ eyes only” protective orders, which permit only the opposing party’s lawyer, and experts who need the information in order to render an opinion to see it.<sup>97</sup> Although these orders are not altogether uncommon, it is difficult to predict when they will be granted. As a consequence, it might be desirable to adopt more precise procedural rules that would enable parties to predict when such orders would be granted. This might, in turn, lead plaintiffs with a secrecy interest to file suit in some cases where under existing rules they would not. Alternatively, amending procedural rules to permit transactors to include a summarily enforceable clause in their contract providing that all damages information in any suit on the contract would be subject to these orders, would restore the threat of a potentially aggrieved party to sue and result in

---

96. For a discussion of the possible benefits and costs of bifurcation, see William M. Landes, *Sequential Versus Unitary Trials: An Economic Analysis*, 22 J. LEGAL STUD. 99 (1993). Bifurcation may also help partially protect some secrecy interests. A plaintiff might, for example, be willing to forgo her secrecy interest if she knew she would prevail on liability, but might not be willing to do so before she knew whether or not she would prevail. In certain types of intellectual property disputes where the calculation of damages typically involves the revelation of information that might be used against the plaintiff by the defendant or other parties, courts often grant bifurcation. See, e.g., *Orgel v. Clark Boardman Co.*, 20 F.R.D. 31, 31-32 (S.D.N.Y. 1956) (granting the defendants’ motion to stay damage-related discovery in “an action for copyright infringement and unfair competition,” between two law-book publishers, pending the establishment of liability, explaining that “business competitors in the law book publishing field are involved as opposing parties, and to allow an extensive discovery into the issue of damages might result in an unnecessary disclosure of defendant publisher’s business affairs to plaintiff competitor”). To the extent that making bifurcation more routinely available in contract disputes would be viewed as objectionable because it places a greater burden on the courts, perhaps requiring the impaneling of two juries, an additional filing fee could be required when a bifurcated case in fact enters the damages phase.

97. These orders are given pursuant to FED. R. CIV. P. 26(c)(7), which provides that a party may request a protective order to protect trade secrets as well as “confidential research, development, or commercial information.” See generally 6 CHARLES ALAN WRIGHT ET AL., *FEDERAL PRACTICE AND PROCEDURE* (2d ed. 1990) (citing cases dealing with the availability of “lawyers’ eyes only” orders); see also *American Oil Co. v. Pennsylvania Petroleum Prods. Co.*, 23 F.R.D. 680, 684 (D.R.I. 1959) (compelling defendants to provide answers to interrogatories—relating to their counterclaims for damages arising from plaintiff’s breach of a contract—which would require them to reveal the names and addresses of their current customers along with the quantities they each purchased, as well as the names and addresses of their former customers together with the reasons these customers terminated their contracting relationship with the defendant, but holding that because “the plaintiff and the defendant are to a certain extent competitors,” access to the answers “should be limited to counsel for the plaintiff and to such persons as he may engage to assist him in any investigation which he may make in preparation for trial”); *Melori Shoe Corp. v. Pierce & Stevens, Inc.*, 14 F.R.D. 346, 347 (D. Mass. 1953) (ordering answers to certain interrogatories to “be disclosed only to counsel for plaintiff and technical experts assisting in the preparation of plaintiff’s case”).

more efficient breach-or-perform incentives in at least a subset of cases in which secrecy is important. More generally, without going beyond the bounds of existing doctrine, these orders could be used to at least partially protect secrecy interests if courts were to explicitly recognize that much of the financial information needed to establish expectation damages has a secrecy value to the plaintiff that may be as great as the secrecy value of a more traditional trade secret, even in contexts in which the parties are not competitors.<sup>98</sup> However, because the lawyers who see the information subject to these orders may well play a role in subsequent negotiations between the disputing parties, the use of these orders may only partially protect a secrecy interest.

#### E. *The Potential Value of Procedural Flexibility*

In thinking about whether transactors would value the ability to alter the mix of monetary recovery and information revelation available under existing doctrines and adjudicative procedures, it is interesting to note that in merchant-run private legal systems, where disputes are resolved in trade-association-run arbitration tribunals that operate under substantive and procedural rules adopted by the merchants whose transactions they govern, the substantive rules commonly provide for objective measures of damages, and wide-ranging party-initiated discovery is not typically permitted. Instead, parties present the information they are willing to reveal and arbitrators are given the power both to request more information and to make adverse inferences about a party who, despite a request, refuses to provide it.<sup>99</sup> This suggests, though by no means proves, that transactors might well benefit from having a choice of a wider array of damage rules and procedural options than they do under current law. The rules of civil

---

98. See *Louis Weinberg Assocs. v. Monte Christi Corp.*, 15 F.R.D. 493, 495 (S.D.N.Y. 1954) (granting, in a contract dispute, a defendant's motion to compel the plaintiff to reveal the names of its customers over the objection that the identity of its customers was a trade secret, explaining that "[t]here is no absolute privilege which protects such information," particularly since "[p]laintiff and defendant are not competitors"); see also *Covey Oil Co. v. Continental Oil Co.*, 340 F.2d 993, 999 (10th Cir. 1965) (enforcing witness subpoenas over an objection that doing so would force the witness to "divulge trade secrets," on the grounds that "[t]he claimed trade secrets do not relate to processes, formulas, or methods, but rather to price, cost and volume of sales . . . . No absolute privilege protects the information sought here from disclosure in discovery proceedings."); *Maritime Cinema Serv. Corp. v. Movies En Route*, 60 F.R.D. 587, 589-90 (S.D.N.Y. 1973) (ordering the defendant to answer an interrogatory relating to the identity and terms on which he dealt with his customers, over his objection that "since plaintiff has systematically attempted to persuade defendants' customers to switch to plaintiff, to divulge the terms of the licensing arrangements would enable plaintiff to offer better terms and thereby to take away these customers," on the grounds that though "[c]ourts have occasionally protected information relating to business contracts and customer lists, . . . this material is not absolutely privileged").

99. See Lisa Bernstein, *Private Commercial Law*, in 3 *THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW*, *supra* note 1, at 108.



procedure might, for example, be amended to provide for a limited discovery track that transactors could opt for through inclusion of a contract provision,<sup>100</sup> which would be another way of at least partially protecting the secrecy interest in situations where transactors find it desirable to do so.<sup>101</sup>

It is important to note, however, that without accompanying substantive law reform, procedural changes alone cannot adequately protect the secrecy interest. Even if the rules of procedure permitted transactors to contract freely as to the amount and type of discovery that could be obtained in the event of a dispute, the problems created by the existence of secrecy interests would not be entirely solved. During the course of negotiations over discovery-limiting contract provisions, transactors would be sending signals about the type of information they wished to keep private—signals that might themselves undermine the secrecy interest as much as, or more than, the negotiations leading up to inclusion of a liquidated-damages provision. For example, a request to limit access to cost data might well suggest that this information had a secrecy value. If, however, transactors could simply contract for an objective measure of damages—particularly a contract-market based measure—the signal sent would be sufficiently noisy to protect most of the value of their private information.<sup>102</sup> Thus, the analysis presented here suggests that, to the extent that secrecy interests are in fact important to transactors, changes in procedural rules and substantive law may well be warranted.

#### IV. CONCLUSION

With a view toward refining, rather than challenging, the well-established literature on the economics of contract damages, this Essay has identified the breached-against party's secrecy interest as a concern that ought to be taken into account in the analysis of damage remedies, and has begun to explore the ways that taking it into account might influence the analysis of the desirability of various remedial rules. More specifically, it has suggested that once the information-related effects of the

---

100. Such approaches are already used in some state courts. Delaware permits contracts between corporations to include a provision providing that in the event of dispute, discovery will be limited in time and amount, and a trial will be held in front of two superior court judges and one chancellor. When certain amount-in-controversy limits are met, the parties may also elect this procedure at the time the dispute arises. See DEL. SUPER. CT. CIV. R. (Part XV, Interim Rules Governing Actions Subject to Summary Proceedings for Commercial Disputes).

101. However, greater procedural freedom without substantive law changes will only partially protect the secrecy interest, because the secrecy interest is jeopardized not only by the fishing-expedition-type discovery, but also by the revelation of precisely the type of information needed to establish the magnitude of damages under existing damage measures.

102. The noisiness of the signals sent by a procedure-based opt-out could be increased if the rules provided a menu of discovery options that transactors would have multiple reasons for selecting.

remedy on the aggrieved party's incentive to sue are taken into account, undercompensatory objective damage measures that do not rely on firm-specific information may result in more compensation to aggrieved parties than perfectly compensatory expectation damages that are based on subjective, firm-specific information.

More generally, identifying the secrecy interest suggests that there is a real, information-related cost to seeking compensation. The existence of this cost may help explain why businessmen attach so much importance to the reputations of their transactional partners even in contexts in which fully compensatory expectation damages could be easily calculated and awarded by a court. Because reputation sanctions do not require an aggrieved party to reveal information about the magnitude of the loss she suffered, she may have a credible threat to impose them even when she does not have a credible threat to sue for damages.<sup>103</sup> Their availability may therefore play a crucial role in regulating the promisor's breach-or-perform decisions. In a similar vein, the existence of secrecy interests may also partially account for businessmen's rejection of the Holmesian notion (and, along with it, the notion of "efficient breach") that a promise in a contract is nothing more than a promise to perform or to answer in damages for nonperformance.<sup>104</sup>

---

103. In a companion article, one of us explores in some detail the way that the existence of strong buyer's-side secrecy interests in transactions between cotton merchants and cotton mills can explain the preference of the industry's merchant-run private legal system for hybrid monetary and reputation-based nonlegal sanctions—more particularly, undercompensatory market-difference plus fixed-penalty-based monetary damages and strong reputational sanctions. See Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Value Creation Through Rules, Norms and Institutions* (draft on file with authors).

104. See OLIVER WENDELL HOLMES, JR., *THE COMMON LAW* 300-01 (Little, Brown & Co. 1944) (1881).